Company Name: Costco
Company Ticker: COST US
Date: 2017-12-14
Event Description: Q1 2018 Earnings Call

Market Cap: 81,511.67
Current PX: 186.53
YTD Change($): +32.64
YTD Change(%): +21.210

Bloomberg Estimates - EPS
Current Quarter: 1.401
Current Year: 6.482
Bloomberg Estimates - Sales
Current Quarter: 32450.750
Current Year: 137827.400

Q1 2018 Earnings Call

Company Participants

- Richard A. Galanti

Other Participants

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

MANAGEMENT DISCUSSION SECTION

Richard A. Galanti

Financial Highlights

Net Income

- In today's press release, we reported operating results for Q1 FY2018, the 12 weeks ended November 26
- Reported net income for the quarter came in at $640mm, or $1.45 per share
- That's a 17% increase compared to last year's first quarter results of $545mm, or $1.24 per share

Stock-Based Compensation and Gross Margin

- In comparing the y-over-y results, there were two items noted in today's release
- First one, this year's first quarter, it benefited from $41mm, or $0.09 per share income tax benefit related to a change in accounting rules for stock-based compensation
- And secondly, last year's first quarter results benefited from a nonrecurring $51mm legal settlement
  - This $51mm figure represented a 19 basis point benefit to gross margin and a benefit to Q1 2017's EPS of $0.07 per share

- So excluding those two items, the reported 17% increase in earnings would have been up 16%

Hurricanes Irma and Maria

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

Sales

- Now turning to the income statement, I'll start with sales
- Net sales for Q1 were $31.12B, a 13.3% increase from last year's $27.47B
- While this year's 12-week quarter included one less sales day in the United States than Q1 last year due to the calendar shift of Thanksgiving, our pre-Thanksgiving and Black Friday holiday weekend sales fell into Q1 this year, compared to have falling into Q2 last year
- Combined, these two factors produced an estimated net benefit to this year's first quarter sales results by an estimated 1.5% in the U.S. and about 1.3% worldwide

Ex-Gas and FX

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

E-Commerce

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

Sales Metrics

- In terms of Q1 sales metrics, first quarter traffic was up 5.9% worldwide and 6.6% in the U.S

- Again, these two figures positively impacted by the Thanksgiving holiday shift, as just discussed
- FX impacted total sales by about 110BPS and gasoline inflation contributed another 142BPS
- So gas and FX together for the entire company was about 2.5 percentage points, 250BPS

Gas and FX Benefit

- As well, cannibalization weighed in on comps to the tune of minus 105BPS
- For the last several quarters, we've had more impact from that as we've done several more relos than we had done in the past
- Average front-end transaction or ticket was up 4.3%
- And again, a little over half of that which was the gas and FX benefit
  - So about a little over 2% normalized transaction figure up

Membership Fees

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

Membership Renewal Rate

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

Paid Executive Members

- In terms of number of members at Q1 end, in terms of total households at Q4 end, we had 49.4mm
- We ended Q1 end 12 weeks later with 49.9mm, up right at 1% during the 12 weeks
- And total cardholders at Q4 end 12 weeks ago, we had 90.3mm cardholders, now 91.5mm
- In terms of paid Executive Members, they stand at 18.8mm, and that's an increase of about 246,000 over the past 12 weeks

- We're still being able to convert and add new Executive Members at the rate of about 21,000 a week in the quarter

Gross Margin

- Again, I mentioned earlier in terms of the portion of the membership fee increase related to the recent annual increase, that y-over-y number will continue to increase, and we'll share that with you each quarter going forward
- Going down to the gross margin line
- Our reported gross margin in Q1 was lower y-over-y by 33BPS
- I'll ask you to just jot down two columns of numbers, not four
- Just for Q1 and basically what we reported for Q1 2018, and the second column would be without gas inflation, since that was impactful to understanding the numbers

Ex-Gas Inflation

- The first line item is merchandise core
- Y-over-y on a reported basis, it was down 12BPS
- Ex-gas inflation, it was flat or zero
- Ancillary businesses plus 6BPS on a reported basis and plus 9BPS ex-gas inflation, 2% Reward, minus 1 basis point and minus 2BPS
- Other, minus 26BPS and minus 26BPS
- So all told, on total, on a reported basis that was the minus 3BPS, if you add up those numbers
- And ex-gas inflation, it was a minus 19BPS

Core Merchandise Component Margin

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

Ancillary and Other Business Gross Margin

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

Reward

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

SG&A

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

Core Operations

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

Central Expenses

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

- As we've been told, higher sales drives slower SG&A

North America

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

Debt Offering and Dividend

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

Pre-Tax Income

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

Tax Rate

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

- As I mentioned early in the call, again, we mentioned that a positive discreet tax item this year

CapEx

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

Warehouse Expansion

- Warehouse expansion, so I think we talked about, we expect somewhere between 20 and 25 openings
- Over half of them will be in the U.S
- We expect three in Canada, two in Korea and one each in Australia and Mexico
- As well we plan to relocate six warehouse this year, four in the U.S. and two in Canada
- And that, again, compares to two, three a year in recent years
  - We've opened quite a few extra in FY2017 as well

Share Repurchasing

- As of Q1 end total warehouse square footage stood at a 108mm square feet
- In terms of stock buybacks in all of FY2017, we spent $473mm for just under 3mm shares at an average price of $157.87
- In Q1, we repurchased 734,000 shares for $119mm or an average price of $162.51
- Needless to say, we've repurchased more stock earlier in the fiscal quarter

Credit Card Relationship with Citi Visa

- Before I turn it back to Christy for Q&A, I'll give you a quick update on e-commerce and our credit card relationship with Citi Visa
- Worldwide e-commerce sales in Q1 2018 were $1.3B, up 40% y-over-y
- Again, somewhere between 5% and 10% of the benefit was the holiday shift
  - We continue to improve our offerings and we continue to improve our member experience with better search, checkout and returns processes
- In the quarter, our site traffic conversion rates and orders were up nicely y-over-y and we enjoyed basically stronger metrics for both the Thanksgiving Black Friday week as well as Cyber Monday, which falls into Q2 this year and last year

Costco.com

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

Executive Membership

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

Back-To-School Labor Day Weekend

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

Citi Visa Anywhere Card

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

Closing Remarks

Lastly, our FY2018 second quarter scheduled earnings release date for the 12-week second quarter ending February 18

This again will be after the market close on Wednesday March 7, with the earnings call that afternoon at 2 p.m

- So, we'll release the earnings shortly after the market closes, and, at the top of the next hour, I do the call

QUESTION AND ANSWER SECTION

<Q - Michael Louis Lasser>: Richard, are you now at a – is membership per club now at a growth level that can be sustained from here? And were there any unique promotions that contributed to the growth in that metric that you experienced during the quarter?

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

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

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

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

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

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

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

<Q - Chuck Grom>: Just on the gross margins I think you said the core-on-core was flat. I was wondering if you could shed some color on the Visa benefit, and then also what the total core was as a percentage of their own sales? And if you could just amplify on any of the category color directionally that you gave earlier?

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

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

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

<Q - Chuck Grom>: Okay. So then when you look at the acceleration in your digital sales in November that was really just your core Costco.com business?

<A - Richard A. Galanti>: Yes.

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

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

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

<A - Richard A. Galanti>: Only one business center this year?

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

<A - Richard A. Galanti>: We'll have at least two this year having opened one already and maybe a third. That's just a mention of timing. I think it's currently on the list for right after the FY. A lot of it has to do with timing. In terms of the 20 to 25, histories would suggest that it's the lower end vs. the higher end. There are a couple of – and the real difference is not things that we don't have on the plate already, it's can we push them, do we get lucky with weather in the winter as we push a couple based on when different hurdles occur with permits, or whatever.

<Q - John Heinbockel>: All right. And then, just lastly, you also, you talked about the gas benefit. Was that de minimis or how big was that?

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

<Q - Karen Short>: First, just a housekeeping question. What was inflation in the quarter, did you give that?

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

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

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

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

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

<Q - Karen Short>: Okay. And then, lastly, how many units on BOPUS right now?

<A - Richard A. Galanti>: I'm sorry how many units...

<Q - Karen Short>: Are on the buy online, pick up in store for those small number of items.

<A - Richard A. Galanti>: Very limited.

<Q - Karen Short>: Okay. Thank you.

<A - Richard A. Galanti>: Hold on, hold on. All warehouses are doing jewelry and laptops in U.S.

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

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

<Q - Simeon Ari Gutman>: Okay. And what about the environment? Is it any different as far as competitors being promotional for new members, is there anything to call out vs. how it looked like in the past?

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

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

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

<Q - Daniel Thomas Binder>: So first question was on the Visa cardholder. I'm just curious, you're over a year in now, do you have any comparative data on how that cardholder is spending in the club vs. the AmEx cardholder previously?

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

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

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

<Q - Daniel Thomas Binder>: And lastly, do you have any...

<A - Richard A. Galanti>: We were pleased with what we saw in Q1 compared to Q4 end.

<Q - Daniel Thomas Binder>: And then lastly, do you have any numbers around membership growth in comp stores?

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

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

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

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

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

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

<A - Richard A. Galanti>: No, no, no, within the 26BPS is 19BPS and that 26BPS was that $51mm legal settlement benefit to gross margin in Q1 of 2017 a year ago. So y-over-y, it was minus 19BPS. So what we're talking about is the other 7BPS.

<Q - Chris Horvers>: Okay.

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

<Q - Chris Horvers>: And then the 1.5 point sales shift?

<A - Richard A. Galanti>: That's for Q2.

<Q - Chris Horvers>: Yes.

<A - Richard A. Galanti>: Yes.

<Q - Chris Horvers>: That's a headwind?

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

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

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

I think it's – I remember when those numbers were coming down, we were asked and like you just said, we said maybe it's new normal; we don't know. We felt good about our business. And one of the things we did is said how can we get it more exciting out there. And part of that was pricing and the like. So we also had a little bit of a hiccup from a traffic standpoint with the multi-vendor mailers. If you recall, the good thing is, is fewer items with greater values and more sales in an MVM. However, the offset to that was, we probably dug a little deeper than we should have in terms of fewer MVM days and during the course of the year. And we saw that impact basically December of 2016 to February or March of 2017, so pretty much Q2 of FY2017.

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

<Q - Edward J. Kelly>: And just a follow-up on the tax reform. I know it's a difficult question to ask, but maybe we think about it in like bigger-picture sense of investment and how you think about driving sales. And when you think about sort of like where you'd like to spend money, particularly if you were to potentially get some windfall, everyone sort of thinks about price. But are there other things that are sort of like – would really like to have but are expensive or an earnings headwind currently that makes the return calculation a little different, whether it's enhanced digital or fulfillment or something on labor? I'm just trying to figure out, are there other areas of the business besides just price that you're sort of thinking about that you would like to invest in if you had the opportunity?

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

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

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

<Q - Matthew J. Fassler>: Okay. And then another question. You were asked on e-commerce about profitability as related to category shift. If you think about the growth of the business, you think about some of the accommodations you're making and the incremental offers that you are providing. And can you talk a bit about the gross margin profile of e-commerce in total? I think you addressed it briefly, I think, as part of the gross margin discussion. But any sense as to the direction of the – and I also know it's small, you made that point as well. Just as it gets bigger, is the direction you're taking it in moving the gross margin in that category one way or the other?

<A - Richard A. Galanti>: Look...

<Q - Matthew J. Fassler>: Through that channel I guess I should say.

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

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

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

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

<Q - Paul Trussell>: Just to follow-up on the e-commerce conversation. You've had a series of announcements on the last few calls including partnerships and the buy online, pickup in store, CostcoGrocery. I just wanted to take a step back, real quick, Richard, and if you can just talk about overall kind of your mind-set and approach to e-commerce and kind of omni-channel and what's kind of led to, I think, a lot of us view this as a bit of a turn in the narrative in the way that you all have kind of approached the business historically?

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

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

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

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

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

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

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

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

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

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

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

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

<Q - Kelly Ann Bania>: Just curious on the SG&A line, you mentioned some incremental costs to think about over the next few quarters. Can you quantify that at all for us? And in terms of the shift, was there any impact, the calendar shift to SG&A, or membership, or any other line items in the quarter?

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

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

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

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

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

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

But we looked at it and said where are some areas where it might make sense? And so we're trying. Tires it makes sense, and that's been very successful over the last year, year and a half, where you can order the tires online to go to the location that you want them installed at, your traditional warehouse that you shop at. And that's driven – in our view, that's driven volume to the tire business for us.

<Q - Kelly Ann Bania>: Anything from the auto replenishment?

<A - Richard A. Galanti>: No comment at this point. We'll let you know if and when we decide. We're looking at that and some other things, but...

<Q - David A. Schick>: We've talked a lot about digital and what you're trying digitally. My question is what you're seeing digitally in e-commerce. Is that causing any merchandising decisions, pushing anything back to the clubs? Are you noticing anything in those trends that could change your merchandising? Thank you.

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

<Q - David A. Schick>: Okay.

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

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

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

<Q - Scott A. Mushkin>: So a couple housekeeping items and then a question. I don't think we've talked much about inflation or if we did, I missed it, and I want you to – what did the inflation look like in the quarter, what's your outlook?

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

<Q - Scott A. Mushkin>: Okay. Yeah, then cost of hurricanes? That's another – I think you said there was a cost? I didn't hear what you said what the cost was.

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

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

So, I guess just from a philosophical perspective, since your sales are so darn strong, why are you guys moving so aggressively with some of these e-commerce either trials or even just rolling it out? It seems that if I look at it over time, it could be harmful to keeping people in your warehouses. And I just want to know philosophically what made you guys change your mind and why you're doing it?

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

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

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

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

<Q - Scott A. Mushkin>: All right. I appreciate the answer and I give a shot-out to that tire program. It's actually – it's pretty good. So anyway, have a good holiday.

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

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

<Q - Chuck Cerankosky>: By Internet, you mean e-commerce?

<A - Richard A. Galanti>: Yes.