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COMPANY INTERVIEW

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Costco Wholesale Corporation (NASDAQ:COST)

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Costco Wholesale Corporation (NASDAQ:COST)



RICHARD A. GALANTI, 60, is Executive Vice President, CFO and Director of Costco Wholesale Corporation. He joined Costco Wholesale Corporation in March 1984 as Vice President, Finance; became Senior Vice President and Chief Financial Officer of Costco in January 1985; and in 1993, Executive Vice President and Chief Financial Officer. In January 1995, Mr. Galanti also became a director of the company. From 1978 to February 1984, Mr. Galanti was in investment banking with Donaldson, Lufkin & Jenrette Securities Corporation, New York. During his tenure at Donaldson, Lufkin & Jenrette, Mr. Galanti provided a variety of financial-related services to both public and private corporate clients. Mr. Galanti received his MBA from the Stanford University Graduate School of Business in 1982 and his B.S. in economics from The Wharton School, University of Pennsylvania

in 1978. Mr. Galanti is currently serving a three-year term on the board of the Federal Reserve Bank of San Francisco and has been on the Foster School of Business Executive Education Advisory Board since 2000.

SECTOR — RETAIL

(BAB601) TWST: Costco was the first company to ever grow from zero to \$3 billion in under six years. What enabled that fast growth?

Mr. Galanti: This was back in the early 1980s; it was a new concept, a combination wholesale/retail, membership warehouse club. It was based on selling large quantities and sizes of quality goods at very low prices. Over the years, we have expanded the types of products and services we offer but never wavered from our core principle of offering great-quality merchandise at the lowest possible prices. We were able to work on lower markups on the goods we sold based on the efficiencies afforded by a limited product selection, larger pack sizes, more efficient packaging, a lower operating-cost structure and more buying power.

If you think about a traditional full-line supermarket today, there might be 40,000 different items being offered — 30 or 40 different SKUs of canned peaches alone. At a full-line supercenter, up to 200,000 items. At Costco, across all categories, from automotive to diamonds to mayonnaise to chickens, we have about 3,700 active items in a location at any given time. So by selecting what we believe are, first of all, high-volume, great-quality items at the best price, and with that core value principle of being the best value out there, we drive a lot of sales. And that's been our M.O. since our inception.

TWST: What is unique to Costco's mission and corporate culture that has contributed to its success?

Mr. Galanti: One of the things we've been known for over the years is our corporate culture, and given our success, there is always concern as to: How the heck are we going to be able to maintain it? I'm proud to say that we have, as a company, been successful at maintaining the culture that has made us the success that we are. And this has been maintained even as some of the early executives are transitioning to retirement. If you go back to the core basics of our company, you start with the mission statement of wanting to provide our members with the best quality and value on

goods and services at the lowest possible prices.

And we do that not by paying lower wages. To the contrary, we do it in the environment where we have annual employee turnover of around 10%, which in retail is off-the-charts low. Why do they stick around? Because we pay well, we provide great health care benefits, and we hopefully provide good opportunities in an open-door, fair work environment. I'm personally very proud of this.

And if you go back to the culture, again, traditionally in retail, you'll see some things below cost to get the customers to come in. Then, you see some other items where you can make a little extra margin. And that's OK. There is nothing wrong with that. But our core principle from the beginning of time was to identify and sell, across many product categories, great-quality items at the lowest possible prices.

And we constantly drive the volume and sales up, and the prices down. And as we can drive sales up, we're gaining even more purchasing power and more production efficiencies, or more packaging or freight efficiencies. And rather than keeping that savings, we figure out how much lower we can go on the price because that will drive the productivity loop of constantly driving more sales, which drives more productivity, which allows us to lower prices even further. And I don't think there is any company that has done this to the extreme and as consistently as we have over the years.

Some of the other aspects of our culture are, again, that we pride ourselves in providing great wages and benefits to our employees. We hopefully provide a good work environment that is open and transparent, and provides opportunities for growth. We have to constantly work on these things. So our employees know that when there is an issue, we are going to look at it; we are going to address it. It's not going to fall on deaf ears, whether it's an hourly employee issue in a warehouse in Philadelphia or something here at the home office.

And that open-door policy is time-consuming, but it works. And it works because we walk the walk. So I think, in terms

of the culture of Costco, having an open-door policy, providing good wages and benefits means turning over our people less because they want to stick around. And these things are going to become the magic of what we have done.

“At the end of the day, the reality is that you have to perform long term over time. We pride ourselves that we’ve been very consistent in our message. We’re going to do what’s right for the company long term, even if it impacts us short term.”

TWST: Looking back over the recent past, where have you captured the tailwinds? And what have been the challenges that have impacted your overall business or particular segments?

Mr. Galanti: Well, since the financial crisis in 2008, when the whole economy in the U.S. and around the world was starting to crumble, we have had some of our best results during the succeeding seven calendar years, 2009 to 2015. And our member shopping trips have increased year over year, while our membership renewal rates have continued to improve and are above 90% in the U.S. and Canada — 88% worldwide. The amount of times on average that an existing member shops compared to the year before, that increase each year, year over year, has been the greatest in each of these last seven years, as compared to the 20 prior years. Now, there are a lot of reasons for that. Part of that is the value proposition; part is that initially in the financial crisis there were people eating out less, and food is certainly an important part of our business in terms of the quality and the value and driving people into our locations to shop.

TWST: In 2014, Costco opened an online store in China via Alibaba. How is that going? What are future plans to evolve Costco to meet the rise of online commerce?

Mr. Galanti: First of all, our online e-commerce business worldwide is a little under \$4 billion. In the past several years, it’s grown in the mid- to high-teens year over year. It is still small as a percentage of our company, less than 4% of our \$100 billion-plus business. In terms of Alibaba Tmall, we are offering approximately 160 items on the Tmall site. Many of them are private-label Kirkland Signature items, and it’s been a success thus far.

What we found was that many of these items were being sold by entrepreneurs, buying them at Costco — perhaps in Taiwan, perhaps elsewhere — and selling them on Tmall, buying them from us and then marking up above that. So now we can do that ourselves at a better price to the customer. It’s also telling people who we are and what we do. Over many years, the Kirkland Signature name, which stands for great value and great quality, is certainly an important aspect of what is popular throughout the world, including in China, be it food items, apparel items and other items.

TWST: Many bricks-and-mortar retailers see the trend to online commerce as a significant headwind. How has Costco been able to rise above that?

Mr. Galanti: Every day is a challenge, just like the warehouse club industry, over the last 30 years, took its store of traditional supermarket sales and sales from many other product categories as well. Certainly, online is taking pieces of different businesses. Everyone is constantly asking the question, “What about Amazon? What about Kroger.com? What about Walmart.com and all the dot-coms?” It impacts different segments and different companies within each segment differently.

Everyone says that brick-and-mortar apparel is challenged. Part of that challenge is what we have accomplished in-store — driving apparel sales with increases of 10% to 20% yearly in each of the past few years. Additionally, we believe fresh foods, which is a signature category for us and is over 15% of our business — we believe no one compares to us in terms of quality and value of what we do in fresh foods. It is one of the areas that drives our business.

TWST: What are the demographics for the typical Costco shopper compared to the overall consumer market?

Mr. Galanti: Compared to the U.S. population, overall, where the average household income in the U.S. last year was \$67,000, for Costco it averages \$92,000. Home ownership: 74% in the U.S. versus 86% at Costco. College graduates: 28% U.S., 41% at Costco. So our demographics, certainly from a retailer’s perspective, are wonderful to have. The average age in the U.S., a Costco member versus the U.S. adult population is two years older — at Costco, 52 versus 50 overall.

I might add, that the two-year gap was a four-year gap just a few years ago, meaning that the average is coming more in line. Why? Millennials. While investors sometimes express concern about the Millennials — “They don’t want to go shop in bulk and drive to these big warehouses.” Guess what? They do. We have been very successful in organics. In just a few years, we have gone from very little to being the largest seller of organic food items in the world, whether it’s produce, protein and even a few nonfood categories.

TWST: How does Costco’s success as a company translate into its success as a stock? How have you created shareholder value?

Mr. Galanti: First and foremost, we create shareholder value over the long term, and I’ll give you one example. A number of years ago, one of the equity analysts stated — when we had missed our quarterly earnings results and our stock price fell — they stated, “It’s better to be a Costco customer than it is to be a Costco shareholder.” And the problem, they went on to say, the problem is they love Costco as a company, and they love to shop there, but the problem with Costco as a stock is that Costco’s view of long term is too long — because we’re going to do what’s right for the long term, even if it negatively impacts short-term results.

And I remember how Jim Sinegal, our Co-Founder and really the spirit of the company in terms of merchandising and operations, responded. His response was that the problem with Wall Street, for them, long term is next Tuesday. At the end of the day, the reality is that you have to perform long term over time. We pride ourselves that we’ve been very consistent in our message. We’re going to do what’s right for the company long term, even if it impacts us short term.

So when the economy turned down and sales slowed a little bit, we’re not going to cut our employees’ wages. We’re not

going to reduce some of the health care benefits. We're going to get through it. And even if that makes the numbers a little tougher in the short term, it's what's right to do for our employees. It's what's right to do for what we believe is the long-term health and profitability of the company. The good news is that it's worked. If it didn't work, it would be a noble idea, but I probably wouldn't be here.

If I look over the years since we went public in 1985, in late December of 1985, just looking at a chart here, the S&P 500 has grown at 8.2% compounded a year. Our stock has grown at 16.5% compounded a year. On a compounding basis, \$1 in the S&P 500 would be great at 8.2%; you'd have about 12 or 13 bucks for each \$1 you invested. Instead, with Costco, you'd have over \$100.

So again, long term, we've been great. We've been great in good and bad economies. We have bumps along the way. But I think the view that we're going to do what's right long term, I don't think anybody has done it as extreme as us across the industry in terms of being upfront with the shareholders, letting them know what we're doing and how we're doing it, and that we're going to do it right for the long term.

TWST: Has there been any important M&A at Costco? What's the growth strategy going forward?

Mr. Galanti: The only M&A we've done was in 1993 when the Price Company and Costco, both membership warehouse clubs, merged. Several of the people that started Costco in 1983 originally worked in San Diego for Sol Price at the Price Club starting in 1976 or, for the 20 years prior to that, at a company called FedMart, where Sol Price was President. So it was really like two parts of the family getting back together when the merger occurred. Certainly, we were the two that were most similar in terms of higher-end customers, more wholesale-oriented, more innovative, and offering great quality and value. That's really the only M&A we've done.

We've grown organically over 32 years, and we hire from within, we promote within, and we feel we still have good opportunities to continue to do that. In addition to just opening new retail warehouses, today, we also have some manufacturing and packaging operations. Last year, we sold over 5 million pairs of prescription glasses. For several years in a row now, our optical centers have been ranked number one in terms of great quality and value.

In terms of growth, I don't necessarily foresee us doing anything on the acquisition front other than perhaps the occasional real estate acquisition or two. Our first priority is putting money into the business, growing it. We feel that we still have many opportunities both in the U.S. and abroad. We're fortunate that our concept has essentially worked in all the countries that we've gone into over the years. Sometimes it takes a few years, but we're long-term-oriented.

TWST: What are the challenges for Costco going forward? How will you meet the trend to online commerce?

Mr. Galanti: In terms of e-commerce, we've grown from operating in two countries, the U.S. and Canada, where we have been the longest. In the last few years, we have opened in Mexico, the U.K., Korea and Taiwan. We have a few other countries we'll do in the next year or so, where we also operate brick-and-mortar. We also have our relationship with Alibaba Tmall, which sells in China. And we're also adding more items and categories to our e-commerce offerings.

TWST: Is there anything you would like to share about

your background or a few brief facts about COST's CEO?

Mr. Galanti: Well, the big concern six years or seven years ago was, "What's going to happen when Jim retires? Nobody can take Jim's place." And Jim would be the first person to say, there are plenty of people that can. The key is to maintain, to have someone who can maintain the culture, inspire and drive the business in the right direction. In Craig Jelinek, you have that.

Craig goes back to the FedMart days in Southern California working for Sol Price and Jim and those guys. And at nearly the end of our first year, when we had seven locations, either Jim or someone else called him and said, "This thing is working. We need some more warehouse managers." Craig was in operations, he came up here as a warehouse manager, and he was in operations for a number of years, and then, he went into merchandising. He proved his abilities in both, and he certainly has the culture intact. It was a very smooth transition.

TWST: Recently, COST transitioned from AmEx to Visa, which I believe is now the only credit card accepted. What was behind the change? What are the benefits to COST and to consumers?

Mr. Galanti: In June, we switched to the new Costco Anywhere Card by Citi in the U.S. and Puerto Rico. We now accept Visa cards. The reason for the switch was simple: a better value for our members. With the new co-branded card, our members earn cash-back rewards at the rate of 4% on gas purchases, 3% on restaurants and eligible travel purchases, 2% on all purchases at Costco and Costco.com — other than 4% on gas — and 1% on all purchases elsewhere. It's a fantastic rewards program. In addition to great cash-back rewards for our members, a small amount of the monies being generated under this new relationship will help reduce our company's bank transaction fees. It is truly a win-win.

TWST: What are your final thoughts? Any other information that you think prospective Costco investors should focus on?

Mr. Galanti: First, one should know that Costco's culture, the culture that has made us who we are, is intact — with the new generation of management successfully taking over for those who have been here for 30-plus years. Second, we continue to have ample runway, several years of opportunities for new warehouses; the fact that the concept has succeeded in many countries, many times that doesn't happen. Third, that our strength in areas like fresh foods and quality and value, we believe, is unsurpassed. Fourth, we have great member loyalty. And lastly, we have to continue to look at what is changing out there, and certainly, dot-com is part of that. It is important to not be arrogant about our success. We're reminded of that by Craig every day.

TWST: Thank you. (VSB)

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