
THE COSTCO ECONOMY

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Earnings season never really ends. It is a slow, steady drip of useful–sometimes conflicting–data. But listening closely can be powerful for uncovering both positive and negative trends. For example, American Airlines signaling a weaker–than–expected summer should be taken with a grain of Boeing. Norwegian Cruise Lines is not seeing a problem with its travelers. Not every headline should be taken as a sign. It takes a bit of digging.

When it comes to top-notch operators, Costco is up there with the best of them. The company has a rather wide view of the consumer. From food to furniture, Costco sells it. What did it have to say about the health of the consumer?

In terms of Q3 comp sales metrics, traffic or shopping frequency increased 6.1% worldwide and 5.5% in the U.S. Our average transaction or ticket was up 0.5% worldwide and up 0.7% in the U.S. Foreign currencies relative to the U.S. dollar negatively impacted sales by approximately 20 basis points while gasoline price inflation positively impacted sales by approximately 30 basis points.

But I have to tell you that categories such as the Home division and Toys are categories that have lagged quite a bit post-COVID that with great excitement. I mean, our buyers have come out and delivered some great items at phenomenal values have really rejuvenated those categories. And those are both leading categories for us and sporting goods, toys, furnishings, domestics, all those categories are really coming on very strong now and all of a discretionary nature.

Source: Costco.

For Costco, there is little to no worry about the health of the consumer. The retailer's envied foot traffic? Strong. The categories that have been weak in the post-pandemic period? Those were the leading categories for Costco. That does not align with the narrative of a slowing, struggling consumer. And it should not be readily dismissed, either.

Partly, the shift in consumer behavior–according to Costco management–is due to the deceleration of inflation. With less inflation pressure came a shift in consumer behavior back toward buying more of other categories. While specific to the experience of Costco, the data points should not be dismissed. Not only is the U.S. consumer alive and well, it is buying the more discretionary stuff.

On the inflation front, it's more of the same from last quarter. Across all core merchandise, inflation was essentially flat in Q3. And with Fresh foods close to 0 and slight inflation in food and sundries being offset by some deflation in nonfoods. The deflation in nonfoods was led by hardware, sporting goods and furniture all still benefiting from lower freight costs year-over-year. Keep in mind that when we speak to inflation, or in the case of nonfoods deflation, we're referring to our selling prices.

As inflation has leveled off, our members are returning to purchasing more discretionary items and growth in the category was led by toys, tires, lawn & garden and health and beauty aids. Bakery sales also showed great momentum in the quarter as our Fresh Foods team has reinvented that department with a number of new and exciting items, including the Kirkland Signature Lemon Blueberry Loaf and Morning Buns. Within our ancillary businesses, the food court had the strongest quarterly sales with continued success of the Chocolate Chip Cookie that was added to the food court this year.

Source: Costco.

But surely this is a Costco-specific phenomenon? No, it is not.

Adam M. Orvos

Thank you, Barbara. As previously mentioned, our comparable store sales were up 3% for the quarter, primarily driven by an increase in traffic. First quarter operating margin of 12.2% was up 205 basis points from 10.1% in 2023. This improvement was due to lower distribution, incentive and freight costs that were partially offset by the planned merchandise margin decline. Cost of goods sold during the period improved by 140 basis points. Distribution costs levered by 75 basis points while buying improved by 50 basis points. Domestic freight improved by 30 basis points and merchandise margin declined by 15 basis points as pressure from offering more sharply priced brands was partially offset by lower ocean freight costs. SG&A for the period levered by 65 basis points, mainly due to higher sales. In addition, SG&A benefited from lower incentives versus last year when we significantly outperformed our plans.

Source: Ross Stores.

Ross Stores called out better foot traffic as well. And it sold more “sharply priced” products—that is code for “expensive.” The consumer is shopping more (foot traffic) and buying stuff that was shunned for the past several quarters. That is a meaningful pushback to the narrative of a potentially problematic U.S. consumer.

Then, there is commentary from Constellation Brands. Its Modelo beer brand is the #1 brand in the U.S., and the commentary around the outlook was similar to Costco’s. The consumer? No issues there.

Garth Hankinson

Yes. Just a little bit on the outlook. Per the guidance we provided for FY '25 and consistent with what we laid out at our Investor Day for our beer business, we expect to achieve net sales growth in that 7% to 9% range. That's underpinned by volume growth in the mid- to high single-digit range and then getting 1% to 2% contribution from pricing.

Source: Constellation Brands.

There are certainly headwinds, though. The rise of GLP-1s could be an issue for beer consumption. After the meteoric success of weight loss drugs, many of the staples companies were viewed as at risk. But that might be overplayed for the beer category.

Nadine Sarwat

Now if I play devil's advocate, which is probably what many people in the room are thinking, brand health is fantastic, but there are 3 sort of factors I have been hearing over the last 6 to 9 months. That GLP-1s, I saw an ad for it and a cab here on the way to the airport. The rise of legal cannabis and also the potential for younger continues to be drinking less.

Now I fully appreciate your view here that brand health is paramount, and that's the first and most important thing to focus on. But how do you consider these potential long-term headwinds to the industry?

William A. Newlands

Well, let's take the GLP diet scenario first. And we said this at Investor Day, Garth, if you remember, we have seen almost no evidence that, that has any impact on our business. And we've listened to millions of conversations with consumers, and it literally comes up about 2% of the time. It's just not a factor.

Similarly, when you think about cannabis, we've studied many of the markets where cannabis has been legal for a longer period of time. And as seen, again, very little to no impact across it.

Source: Constellation Brands.

In fact, Modelo and Constellation's broader beer business has been so successful that it is playing catch-up with its capital expenditures. Where is that capital being invested? Mexico. Again, that is more signal than noise. And it is being done in size.

Garth Hankinson

Well, let me start with overall Constellation [indiscernible] specifically, I don't want [indiscernible] Overall constellation, we've been investing a lot in CapEx, mostly in our beer business. And this is actually going to be our high watermark for CapEx as an enterprise.

This year, we're going to spend about 13%, 13.5% of net sales on CapEx. Again, a vast majority of that in Mexico. And we see over this medium-term period that coming down in our fiscal 2028 to be in the 4% to 6% range. So that's a real inflection for us as [indiscernible].

Source: Constellation Brands.

Why does any of this matter? Because it is the reality of the economy, not a sentiment about the direction. Costco is seeing prices "level off" and the consumer begin to shift spending habits. Both Costco and Ross Stores are seeing foot traffic increase. Constellation is not seeing a consumer slowdown and is investing in capacity to keep up with the demand. None of that is a "maybe." All of that is the reality of the U.S. consumer. Yes, the consumer sentiment numbers have been horrid. But what the surveys say and what the consumer is doing are two wildly different things.

Welcome to the Costco Economy.

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