Q2 2022 Earnings Call

Company Participants

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

Other Participants

- Brandon Cheatham
- Christopher Horvers
- Chuck Grom
- John Heinbockel
- Karen Short
- Kelly Bania
- Laura Champine
- Michael Baker
- Michael Lasser
- Peter Benedict
- Rupesh Parikh
- Scot Ciccarelli
- Simeon Gutman

Presentation

Operator

Good afternoon, and thank you for standing by. Welcome to the Q2 Earnings Call and February Sales Results. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Richard Galanti, Chief Financial Officer. Please go ahead.

Richard A. Galanti {BIO 1423613 <GO>}

Thank you, Jerome, and good afternoon to everyone. I will start by stating that these discussions will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements involve risks and uncertainties that may cause actual events, results, and/or performance to differ materially from those indicated by such statements.

The risks and uncertainties include, but are not limited to, those outlined in today's call as well as other risks identified from time to time in the company's public statements and reports filed with the SEC. Forward-looking statements speak only as of the date they are made, and the company does not undertake to update these statements, except as required by law.

In today's press release, we reported operating results for the second quarter of fiscal '22, the 12 weeks ended this past February 13, as well as February retail results for the four weeks ended this past Sunday, February 27.

Net income for the quarter came in at $1,299 million or $2.92 per diluted share. Last year's second quarter net income came in at $951 million or $2.14 per diluted share. That latter number included a $246 million pretax or $0.41 per share cost, incurred primarily from COVID-19 premium wages.

Net income for the 24 weeks was $2.62 billion or $5.90 per share compared to $2.12 billion or $4.76 per diluted share last year in the first half. Net sales for the quarter increased 16.1% to $50.94 billion, up from $43.89 billion last year in the second quarter. Comparable sales in the second quarter for fiscal '22, on a reported basis, U.S. sales increase during the 12-week period was 15.8% excluding gas inflation, 11.3%; Canada, 16% reported, 12.4% ex gas inflation and FX; other International, 6.2%; and plus 9% ex gas inflation and FX for the total company reported number of 14.4% on a same-store comparable basis and up 11.1%, excluding gas inflation and FX. E-commerce, on a reported basis, up 12.5% and FX up 12.6%.

In terms of our second quarter comp sales metrics, traffic or shopping frequency increased 9.3% worldwide and up 8.3% year-over-year in the quarter in the United States. Our average transaction or ticket was up 4.6% worldwide and up 6.9% in the U.S. during the second quarter. Foreign currencies relative to the U.S. dollar negatively impacted sales by approximately 60 basis points, while gasoline price inflation positively impacted sales by approximately 390 basis points. I will review our February sales results later in the call.

Going down our second quarter fiscal 2022 income statement. Membership fee income reported came in at $967 million, up $86 million or up 9.8% from a year earlier, $881 million. There was about a $6.5 million impact -- negative impact due to FX. So on an ex FX basis, if you will, the $86 million increase would have been up $92 million or 10.4%.

In terms of renewal rates, they continue to increase. At second quarter end, our U.S. and Canada renewal rate stood at 92.0%, up 0.4 percentage point from the 12-week earlier Q1 end. And worldwide rate, it came in at 89.6%, up 0.6% from where it stood 12 weeks earlier at Q1 end. Our renewal rates are continuing to benefit from more members' auto renewing as well as increased penetration of executive members who on average renew at a higher rate than nonexecutive members, and higher first year renewal rates for our new members. In terms of the number of members at second quarter end, member households and total cardholders, total households was 63.4 million, up 900,000 from the 62.5 million just 12 weeks earlier. And total cardholders at Q2 end, 114.8 million, up 1.7 million from the 113.1 million figure 12 weeks ago.

At second quarter end, paid executive memberships stood at 27.1 million, an increase of 644,000 during the 12-week period since Q1 end. Executive members, by the way, represent now 42.7% of our total membership base and 70.9% of our total sales.

Moving down to the gross margin line. Our reported gross margin in the second quarter was lower year-over-year by 32 basis points, but up 5 basis points, excluding gas inflation. As I always do, I'll ask you to judge on a few numbers, two columns. The first column is reported, the second column would be excluding gas inflation.

First line item, merchandise core. Merchandise on a reported basis was down 75% -- 75 basis points year-over-year and ex gas inflation down 43. Ancillary and other businesses reported plus 40 basis points and ex gas inflation plus 49 basis points, 2% reward, plus 3 and minus 1 basis points; LIFO, minus 14 and minus 14 basis points; other plus 14 and plus 14 basis points. So totally, on a reported basis, again, year-over-year, minus 32 basis points and excluding gas inflation, plus 5 basis points. Now in terms of the core merchandise component being lower by 75 year-over-year reported and 43 -- minus 43 basis points ex gas inflation. Recall last year in Q2 that the core reported was plus 71 basis points and ex gas plus 63, so still improved to where we were two years ago, prepandemic and ex gas.

In terms of the core margin on its own sales, in Q2, are core on core margin, if you will, was lower by 28 basis points year-over-year. Approximately 2/3 of this coming from fresh foods and a little from foods and sundries and nonfoods as well.

Fresh continues to lap exceptional labor productivity and low product spoilage that occurred from the outside sales a year ago in the second quarter. Ancillary and other business gross margin was higher by 40 basis points and by 49 ex gas in the quarter. Gas, travel, business centers and pharmacy were all better year-over-year, offset by e-comm and optical. LIFO, we had a 14 basis point hit year-over-year to LIFO, or $71 million LIFO charge during the quarter, both with and without gas inflation. Recall that our Q1 LIFO charge year-over-year was $14 million or in the first quarter was $14 million or a 3 basis point delta versus the prior year.

It's been the last 3 fiscal quarters that we've actually pointed out LIFO as we saw a little bit of inflation going back to December or Q4 of fiscal '21, a little more in Q1 of this fiscal year. And as with everything you read in the news, quite a bit more in Q2. Our 2% reward was higher on a reported basis by 3% and minus 1, excluding gas inflation, a reflection of increased penetration of the 2% reward executive members, and other was plus 14 basis points year-over-year. This is related to the COVID-related costs from a year ago, about $60 million. That's the portion of COVID-related wages that go into cost of sales that like related to manufacturing businesses as well as their meat and bakery departments. Overall, a pretty good showing on the gross margin, given the ongoing and increasing inflationary pressures.

Moving to expenses, to SG&A. Our reported SG&A in the second quarter was lower or better year-over-year by 94 basis points, and better by 63 basis points, excluding gas inflation, Again, jotting down two columns of numbers reported and the second one, ex gas inflation. Operations, plus 36 basis points and plus 9. Here, a plus is good. It means it's lower year-over-year. Central, plus 13, plus 10; stock compensation, plus 3 and plus 2; other, plus 42 and plus 42, for a total of plus 94 and plus 63. So better or lower by 94 basis points reported and better or lower by 63 basis points ex gas inflation.

Now again, looking at the first line item, operations. The core operations component, better again by 36, but as well better by 9 or lower by 9 basis points, excluding the impact of gas inflation. Keep in mind that this improvement occurred despite both the permanent dollar an hour wage increase that began in March of 2021 is now anniversary-ing and the additional starting wage increases from our two basic hourly scale service assistant and services clerk by an additional $0.50 an hour, that occurred in October of 2021.

On the Central, better by 13 basis points or 10 ex-gas inflation, it's pretty straightforward operating leverage on strong sales figures. Stock comp plus 2 and plus 2, again, reflection of good sales, and other that's plus 42 basis points. This was the $2 COVID wages of $186 million that goes into SG&A in Q2 a year ago. So, again, on a year-over-year basis that was that improvement.

In terms of preopening expenses. In past conference calls, really since we went public, I think, we've covered that preopening expenses next on this discussion. Starting this fiscal year and going forward, preopening is now included in SG&A. The year-over-year change in SG&A related to preopening was flat year-over-year, no basis point delta year-over-year in the second quarter. All told, reported operating income in Q2 increased 35% on a reported basis, coming in at $1,812 million this year compared to $1,340 million a year ago in the second quarter.

Below the operating income line, interest expense was $36 million this year versus $40 million last year. Interest income and other for the quarter was higher by $6 million year-over-year, $25 million this year versus $19 million last year, primarily due to favorable FX. Overall reported pretax income in the quarter was up 37% coming in at $1,801 million compared to $1,319 million a year earlier. In terms of income taxes, our tax rate in Q2 was slightly higher than it was in Q2 a year ago. It came in at 26.7% compared to 26.4% a year ago in the second quarter. Our effective tax rate is currently -- it continues to be projected to be in the 26% to 27% range for the fiscal year.

A few other items of note, warehouse expansion. For the year, we now plan to have 32 new units and -- 32 units, including four relocations, so replacing the existing units to larger and better-located facilities. So, net total of 28. I think, a quarter ago, we actually said it was a net total of 27, so, one more than that. However, remember, several of these are slated to open in Q4 or fiscal Q4. 15 of them -- or 14 net new. So, there's always a potential for one of those to shift into the next fiscal year. The five openings in Q2 that we had, one each in Mexico, our 40th in Mexico, our second in France, our second in China, our fourth in Spain and one additional unit in Florida, where we now have 29 locations.

Regarding capital expenditures, our Q2 spend for CapEx was approximately $723 million and our full year CapEx spend is still estimated to be approximately $4.0 billion.

Moving onto e-commerce. E-commerce sales in Q2 ex-FX, as I mentioned earlier, increased 12.6% year-over-year and that's, of course, on top of a second quarter of fiscal '21 increase of 75% increase last year, benefiting, of course, from COVID. Stronger departments in e-commerce in terms of year-over-year percentage increases were jewelry, tires, special or kiosk items, patio and garden, and home furnishings. Our largest online merchandise department majors, which consists of consumer electronics, appliances, TVs, et cetera. Was up in the high single digits on very strong sales increases a year earlier.

In terms of an update on Costco Logistics, this continues to drive big and bulky sales. For the quarter, deliveries were up year-over-year 22%, and now, about 85% of our U.S. e-com less than truckload shipments from Costco Logistics we're doing ourselves. Average -- during the quarter, we averaged more than 55,000 stops per week with Costco Logistics, which translates into a little over $3 million planned drops in Costco Logistics for the fiscal year. In terms of e-com and mobile apps, it continues to improve. Much improved layout, the ability to view warehouse receipts online, the ability to reschedule e-com deliveries in the U.S. and Canada as well as reschedule returns pickups. Later this month, we'll have our warehouse inventory along with the Instacart inventory online and be able to see all the detail of -- are in line where our in-store merchandise as well.

In terms of our e-commerce platform, Costco Next, we added a few additional suppliers. So we now have 37 suppliers online and growing. Again, Costco Next has about 1,000 items on it, curated items that Costco values. Please give it a -- check it out.

From a supply chain perspective, similar issues that we outlined, both 12 and 24 weeks ago on the past quarterly earnings calls, the factors pressuring supply chains and inflation include port delays, container shortages, COVID disruptions, shortages of various components and raw materials and ingredients and supplies, labor cost pressures, of course, as well as truck and driver shortages. Overall, we've done a pretty good job of -- given these supply chain challenges. I think that's evidenced in our sales strength. They continue to be delayed into container arrivals. So, we continue to advance order in many cases as we were able to. Virtually, all departments are impacted. Less product and packaging challenges, but still a few.

Now, still some limitations on key items, but again, that's improving a little. Chip shortages are still one of the things that are impacting many items, some more than others, but again, we're managing to have our shelves full and driving sales. One of the things that we've done that I mentioned last quarter -- last quarter, I mentioned we had chartered three small container vessels to help provide us with additional flexibility on shipping. We have now chartered a total of seven ocean vessels, up from those three for the next three years. And these are the transport containers between Asia and the U.S. and Canada. We've also leased containers for use in these ships. With these additions, about a quarter of our annual trans-Pacific containers and shipment needs are being accommodated this way, which gives us additional supply chain flexibility.

Despite all the supply chain issues, we're staying in stock and continue to work to mitigate cost and price increases as best we can. From -- every day and every week, you're going to see in different items in different departments certain things on allocation or short, but other things are falling into place, and again, some things are seeming to get a little better.

Moving to inflation. Inflation, of course, continues as evidenced by our LIFO charge. The inflationary pressures that we and others continue to see include higher labor costs, higher freight costs as well as higher transportation demand along with the container shortages and port delays that I just mentioned. Increased demand in certain product categories, various shortages of everything from computer chips to oils and chemicals to resins, higher commodity prices from foodservice oils to additives to motor oils to plastics to detergents to paper products as well on the fresh side, proteins and butter and eggs and things like that. And not very different than what you hear and read and see from others, but again, we think we've done a pretty good job of corralling it as best we can.

For first quarter, a year -- a quarter ago, I mentioned that we estimated at that time overall price inflation to have been in the 4.5% to 5% range. For the second quarter, and talking with senior merchants, estimated overall price inflation was in the 6% range. All of this said, again, I want to give another shout out to the job that our merchants and our traffic department and our operators have all been able to keep -- in order to keep the products that we need pivot when and where necessary to keep our warehouses full like keeping prices as low as we can for our members and continue to show great value versus our competitors.

Now turning to our February sales results. The four weeks ended this past Sunday February 27th compared to the same four-week period a year ago. As reported in our release, net sales for the month of February came in at $16.29 billion, an increase of 15.9% from $14.05 billion a year earlier. Recall from January sales results that Lunar New Year/Chinese New Year occurred on February 1st, that's 11 days earlier this past -- this year than last. This shift negatively impacted February's other international by about 4 percentage points and total company by about 0.5 percentage point.

Comparable sales for the four weeks on a reported basis U.S. was 17.4%, ex-gas and FX 12.9%. Canada reported 11.7%, ex-gas and FX 8.8%, other international minus 0.9% and ex-gas and FX 1.3% to the positive. Total company 14.0% and 10.6% and e-com within that number is 10.2% reported and 10.4% ex-gas and FX. Our comp traffic and frequency for February was up 8% worldwide and 8.2% in the United States. Foreign currencies year-over-year relative to the dollar negatively impacted total comp sales as follows: Canada by approximately two-tenths of a percent, other international by approximately 4.5% and total company by approximately seven-tenths of a percent. Gas price inflation positively impacted total reported comps by about 4% and average worldwide selling price per gallon was up year-over-year by 37%. Worldwide, the average transaction for February was up 5.5%. Our U.S. regions with the strongest sales were Texas, the Southeast and the Northeast. Other international and local currencies saw the strongest results in Australia, Mexico and the UK.

Moving to merchandise highlights for the month of February. Food and sundries was a -- came in at a positive high single-digits. Fresh foods in the mid single-digits and non-foods in the positive high single-digits. Ancillary businesses sales were up mid-40s with gas being certainly a driver of that as well as food court and hearing aids were the top performers.

With that, I want to mention just a couple of recent executive changes. A month ago, we reported that Ron Vachris became President of COSCO. Ron started his career 39 years ago at Price Company and The Price Club at the young age of 17. Most of his career was in operations through 2015. Then he spent a little over a year in real estate, traveling the world and working on both worldwide and domestic expansion. And since that time, in 2016, has been in merchandising with certainly responsibly not only for in-line merchandising but online merchandising as well as very involved with logistics and transportation. As well, just this week, internally, we reported that taking Ron's previous part as Head of Merchandising is Claudine Adamo. Claudine has been with us for 30 years. She began in an hourly reposition in our Kirkland warehouse in 1992, 30 years ago, but a year later, came into buying and has been in buying ever since. And most recently, was Senior VP of Non-Foods sales -- of Non-Foods merchandising and again, she will be taking over or looking over all of merchandising. Finally, in terms of upcoming releases. We will announce our March sales results for the five-weeks ending April 3rd, on a Sunday April 3rd, on Wednesday April 6th after the market is closed.

With that, I will open it up to Q&A and turn it back to Jerome. Thank you very much.

Questions And Answers

Operator

(Question And Answer)

Thank you. (Operator Instructions) Your first question comes from the line of Michael Lasser from UBS. Your line is now open.

Q - Michael Lasser {BIO 7266130 <GO>}

Good afternoon, Richard. Thanks a lot to -- for taking my question. Question is on the fee increase or the potential for increase. If there is no increase this year, should the market interpret that as some reflection of how Costco (Technical Difficulty) pricing power especially in light of the companies like Amazon and Netflix recently -- this year or should we interpret the sign as an interval I wish Costco (Technical Difficulty)

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

Well, certainly, I don't you think should interpret '18 related to why or when. Historically, we always look at things like do we feel -- we look ourselves in the mirror and do we feel that we've continued to increase the value of the membership. Certainly, we look at renewal rates. We look less at what others do frankly, but certainly are -- is out there what others are doing. And what I do note is, is that I've looked at the last past three increases over the last 15 years; and on average, they were done about every 5.5 -- little over every 5.5 years, about 5 years and 7 months. And 5 years from the anniversary of the June of '17 would be this June. So, I think the question will continue to be asked to until we do or don't do something. But at the end of the day, we certainly feel very good about our member loyalty. Our success didn't -- getting members to move to executive member, which are even -- are the most loyal. And so, you guys all know when we tell you and at some point it will happen, but stay tuned.

Q - Michael Lasser {BIO 7266130 <GO>}

Thank you. My follow-up question is on the core-on-core earnings margin over the last couple of quarters, we've given back about third of the core-on-core group margin gained by Costco during the holiday, like over the holiday last couple of years. Is this the right way to think about what sustainable figure you may get back to third of (Technical Difficulty) or alternatively, what you expect --

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

Yes. Look, recognizing -- I'd like to think it was that easy that we could plan it and get there. Sometimes we get there, but 10 different variables go in 10 different directions than we had planned. There's lots of moving parts to it. The fact of the matter is, we certainly have confidence in our competitive position and our confidence to get to margin if -- as we go forth. The fact of the matter is, our margins -- our gross margins are still even on core-on-core higher than they were two years ago. We had outsized margins two years ago most particularly in fresh when you had 20% and 30% increases in fresh, you darn near eliminated spoilage and we're the 2s.

Labor -- you improved dramatically labor productivity in fresh and you darn near eliminated all your spoilage. Some of that's not sustainable, so but even with some of the give backs if you will on a two year's stack if you will, we're still showing higher year-over-year numbers of core-on-core. The other thing is, as we've said, and we don't sit around and just pound our chest on it, despite these inflationary pressures, we've tried to hold where we can. Now needless to say, you can't do that in its near -- in its entirety, but we've probably been a little later than others in terms of raising some things in our view. We've worked with our suppliers to eat a little of it and we eat a little of it.

And I think that these margins, particularly given the sales strength and the operating leverage allow us to be ever more competitive and drive our business. So, when asked the question as many of you know over the years, who's our toughest competitor, it's us. And I don't really look at this as being a reflection of what's going on out there. Wherever competitive, we're always checking our competition and we feel that competitive -- our competitive position is as strong as ever.

Q - Michael Lasser {BIO 7266130 <GO>}

It's very helpful. Thank you. Best of luck.

Operator

Thank you. Your next question comes from line of Simeon Gutman from Morgan Stanley. Your line is now open.

Q - Simeon Gutman {BIO 7528320 <GO>}

Hey, everyone. Good afternoon. Richard, I'd like to follow-up on the core-on-core question, just ask differently. About, I'd say, a year ago, supply chain costs were rising, input costs were rising and it felt like you like you were not ahead of it. And in the last two quarters, it seems like you're now more ahead of it, you feel better, you called out the two-year trend in the core-on-core. So, does it feel like we are past the worse and that you're able to either move pricing or have some visibility on supply chain. And then related to the perishable peace, it sounds like you're going to keep some efficiency, so there is a reason to believe that some of this you will keep going forward. I don't know if that's fair or not.

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

Yes, well certainly on the fresh and the fact that we're at higher sales levels that allows for higher labor productivity and hopefully a little lower D&D or spoilage. I don't disagree with what you say, but there's -- never know what's going to happen tomorrow. I know that for 35 years when things get better, we figure out how to give a little more of it back and certainly right now with all the inflation, first and foremost is getting merchandise on the shelves and then mitigating those various cost components as much as you can, which is not a lot. And again, but hopefully being as if not a little more competitive than others.

Q - Simeon Gutman {BIO 7528320 <GO>}

And maybe a follow-up, I'd love your take on the price gaps out there. It feels like every company we cover in the mass space, supermarket space, they're all pleased with price gaps, and yet, I'm not sure -- I don't know if that's right or wrong and we're seeing gross margins actually start to go up in some places. So, it seems like company is your competition, they're taking price that would imply that the gaps actually should be widening and making you more valuable. Curious -- I know you guys have folks run around stores a lot. Curious how -- what's your take on it?

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

Well, we like when they feel more comfortable frankly. Look, our most direct competitor is Sam's. We -- and I'm sure they too do comp shops every week and every -- every location. We feel good about those gaps, it's not that they've widened or shrunk that overall, they are tough competitor and so are we. As it grades to other traditional, yes, you've seen, yes, I think we've called out strength in gas business. I think, overall, and what I read externally about gross margins and retail gas by the supermarkets and others is up. And there's a little bit more that gives us breathing room as well, but we want to be ever more competitive.

Q - Simeon Gutman {BIO 7528320 <GO>}

Great. Thank you.

Operator

Your next question comes from the line of Chuck Grom from Gordon Haskett. Your line is now open.

Q - Chuck Grom {BIO 3937478 <GO>}

Hey, thanks a lot, Richard. Over the past few months, you guys have had success raising retails and I'm wondering if that trend has continued or if you're starting to see some limits or demand destruction in any parts of the club?

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

Not -- no, we haven't. I think certainly we -- the more inflation creates some demand pressure. I'd like to think some of that inflation -- wanting to shop across -- on the save more, frankly, but we haven't seen that, yeah.

Q - Chuck Grom {BIO 3937478 <GO>}

Okay. Okay, great. And then just another near-term question, historically, I'm wondering if with gas prices where they are and where they're likely to go, I heard today California's close to $5. Historically, has there really been a tipping point and how it impacts traffic for you guys? I understand how it impacts the margin structure of your business, but historically is there a tipping point for you?

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

We haven't seen that. The only time in my recollection is a number of years ago when prices got to $4-$5 a gallon, and like then and now, we see our gallons improve relatively speaking, because we are still the cheapest game in town. So, at some point if it goes to $5 to $7, who knows, will people stop driving a little bit? It's hard today. I would like to think that the hybrid models are working -- little bit there.

Q - Chuck Grom {BIO 3937478 <GO>}

Okay. Great. Thank you.

Operator

Your next question comes from the line of Paul Lejuez from Citi. Your line is now open.

Q - Brandon Cheatham

Hi, everyone. This is Brandon Cheatham on for Paul. Thanks for taking our question. I was wondering, are you seeing any change in consumer behavior such as trade down or maybe trade do private label brands, anything of that nature?

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

It's interesting. On the one hand, the only thing I can think of is -- and fresh when there's been big fluctuations in prices or big increase in prices on beef relative to chicken or something, you'll see some trade down within the protein family. Other than that, a couple of anomalies that are perverse in the sense that this almost just the opposite. We've seen strength in jewelry and in big-ticket furniture items and the like and more conversions to executive membership, which again there's more value long-term to that customer, but it's adding $60 to their fee.

Q - Brandon Cheatham

Got it. And just a point of clarification on price inflation, has that moderated the past couple months, because I think some of your monthly updates have indicated or are you still seeing that accelerate?

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

It is not moderated. It continues to go up.

Q - Brandon Cheatham

Got it. Thank you.

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

Now, it is going up, perhaps at little less slope, the bigger slope was probably four to two months ago, and it's going up from there. I think that if I recall, there is a little low of talking to the buyers, a little low in the last couple of months of the year, but many suppliers are already talking back two months prior to that, to come January, will be coming back and talking to you again.

Q - Brandon Cheatham

Got it. Understood. Appreciate it. Thank you.

Operator

Your next question comes from the line of Scot Ciccarelli from Truist Securities. Your line is now open.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Good afternoon, guys. Scot Ciccarelli. So, Richard, you guys are running with nearly double the cash balance that you historically would have run with kind of pre-pandemic. Obviously, there's still a lot of uncertainty in the market, but I guess the question is, because we've seen this pattern for probably eight-plus quarters now to continue to run with much higher cash levels than what you historically have or should we start thinking about the potential of return of capital to shareholders like you've done periodically?

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

Well, at some point, we'll figure out what to do with it. Mind you, our Q2 balance sheet, Q2 end balance sheet is probably the highest point from a seasonal standpoint, because of you've got a lot of sales and you still have some of the bills to pay from the Christmas time, not a lot, but some. And frankly, knock on wood, our operating cash flow has certainly exceeded what we had expected two years ago. So, yes, there is a little more. At some point, certainly one of the arrows in our quiver is a special dividend along with the regular dividend increase that we've done every year as well as some stock buybacks, but first and foremost is CapEx. CapEx this year of $4-ish plus million is up from the $3 million, $3.5 million over the last couple of years and up from numbers lower than that, the two to four years prior to that. So, that's first and foremost what we want to spend money on. But we've done four specials. And as one of the Board members said, as -- we are a little quirky, and it seems to have worked for us. So, it's certainly an arrow in our quiver, but we haven't made any decision at this point.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Got it. Thank you.

Operator

Your next question comes from the line of Karen Short from Barclays. Your line is now open.

Q - Karen Short {BIO 7215781 <GO>}

Hi. Thanks very much. I just wanted to ask the membership fee question a little differently. So, in the past, you've talked about raising the membership fee in the context that you obviously have inflow of dollars to then reinvest in price. So, I guess the question is maybe with the assumption that that consumer is going to continue to feel a little more and more stretched as the year progresses, how does that factor into your thought process? And then also tying in with the fact that there was obviously the increase on membership at Amazon.

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

I think we -- that doesn't hurt, but honestly, at the end of the day, first and foremost, the factors that doesn't give us any concerns is the fact that our sales are strong, our renewal rates and loyalty are at all-time highs, so that's all positive. And yes, when we do it, we use it to be even more competitive. So, on the one hand, you might argue that because of inflation, will this allow us to mitigate some of that. We're already doing that by the way the way without a fee increase. But we've done it seven times in 35 years and sometime between summer and six or nine months down the road, is it likely, it's possible, but we'll have to wait and see. But we don't really consider what Amazon or what -- we were -- we're asked the question the other way with some of our direct warehouse club competitors that theirs is -- they have not changed their in a number of years and that does not concern us either.

We looked at it, what we're doing, how it affects our numbers. And we look ourselves in the mirror says, have we have we proved the value of the membership. We've always felt that we've done that in a more dramatic fashion these increases, and then we take those increases and use it to become even more competitive. So, I can't give you -- I cannot give you an answer other than we feel good about if and when we want to do it, we'll be able to.

Q - Karen Short {BIO 7215781 <GO>}

Okay. And then, my second question is just on -- net income margin or I guess you could talk about pre-tax margin. Obviously, that has come up quite a bit over the last several years. And I think the question on a lot of people's mind is just is there more of a willingness to flow through margin on that line? And I know again, you don't run your business that way you run it for units and volume and leverage on strong comps, but just wondering how you frame that?

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

Well, yes, first of all, certainly in this quarter as well, the bottom line margin improvement was the sum of great expense improvement and some margin detriment. I'm taking it out all the anomalies of each and that's the way we want to do it. The old saying is we want to lower prices and raise margins. The same thing is we want to improve the bottom line, while not raising prices and I'm not talking about necessarily specific inflation right now. I think, I recall and a few of the few of these on the view on the called might very remember this when we had our very first and last all hands analyst meeting out here with about 300 people. And at the time we had a 2.8% pre-tax return on sales, pre-tax and our founder was up there saying that we are a great company and great companies deserve to make good money. And over the next several years, we wanted to go from 2.8% to a number -- I won't get everybody excited, but a bigger number. And at the end of the day, it went up and down, but it has improved. I think that we've got a lot of great things going on. We're not embarrassed to make money for our shareholders as well. But we're going to do it within the confines of being ever more competitive from a pricing and value standpoint to our members.

Q - Karen Short {BIO 7215781 <GO>}

Okay. Thanks very much.

Operator

Your next question comes from the line of Chris Horvers with JP Morgan. Your line is now open.

Q - Christopher Horvers {BIO 7499419 <GO>}

Thanks. Good evening. I guess my first question is, do you look at the U.S. sort of core comp on a two year to three-year basis? You really sense the summer, there's been a bit more volatility to the two and three year trends even over the past few months. Do you read into that? How much do you think that was maybe just like a holiday shift? Maybe some Omicron impact in January. Curious how you're thinking about that.

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

It would be the all-inclusive yes. It's all the above. I remember when we had particularly strong early in the Christmas holidays -- Thanksgiving, Christmas holiday season, we had strength; part of that was bringing in some things early, part of it was this increased demand that COVID has created for goods for the home, and the shortages of those same goods. And so, once they hit the shelves, you sold quickly and then of course, it was a little it was still positive, but a little less than that trend at the end of the calendar year and without doing a lot of work, it seemed like that was the reason. Then you've got storms that affect the things you got shifts and things like Chinese and Lunar New Year.

We really don't spend a lot of time doing that. We try to understand why overall some level of sales either generally reduced for the increase, we don't worry about it as much.

And but I don't think we spend a lot of time thinking about that. We are, as we've been reminded from the day of our founding, we're a top line top line company and it's all about driving sales and value, and it's going to be as good as we can get it. And so, we don't read a lot into what you asked.

Q - Christopher Horvers {BIO 7499419 <GO>}

Got it. It's a good segue. I guess, your executive trends, the renewal rates, the comps, the traffic, you're one of the few big retailers with really strong traffic. But at the same time, is there a point, where just the culture becomes uncomfortable with passing through price? I mean, the vendors have talked about more price increases that have come starting January 1. It seems like there's more coming in September. I could think of Jim sort of being paranoid and worried about do we just push too far and do we not want to risk that? And invest more in price before even seeing any deterioration in the sales trends.

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

I would say, we're more aggressive when things are good and we're aggressive when things are good and bad. I remember somebody years ago asked the question given that sales for whatever reason had been weak for a month or two. And that was more the reason to be even strong on pricing. And I think that actually had to do related to a pending membership fee increase based on this kind of five-plus year anniversary. And the view was, is no, our members are loyal and we're going to use it to drive more sales. So, no, I don't, I think we're still bored of that same DNA of trying to constantly drive more value and not worry about how strong or weak we are today. Just keep driving more value and if we keep focusing on that, nobody can catch us.

Q - Christopher Horvers {BIO 7499419 <GO>}

And then just one quick -- sorry. Say it again.

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

It's harder to catch us at least, so --

Q - Christopher Horvers {BIO 7499419 <GO>}

Yes. And then, just a quick question on LIFO; if price increases have continued into this year, does that LIFO number just stay at this level; and as we lap through it, do we actually get that back?

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

Well, in theory, you don't get it back. If life is -- as I said earlier, if inflation is continuing, you should see some additional LIFO charges, maybe not as big, but who knows. And at some point at the beginning, you start a new fiscal year, you've had whatever LIFO charge you'll have for this past year and those -- that's kind of the noose set point for costs for each item. And then to the extent, if there's additional inflation relative to that starting point, you'll have some additional LIFO next year. If things came down a little bit, let's say things, I'm making these numbers up in the extreme, but things were up in one year 20% and the next year, they were down 10%, you had a big LIFO charge this year and you actually have some LIFO credit in the following year.

Q - Christopher Horvers {BIO 7499419 <GO>}

Got it. Thank you. Best of luck.

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

I gave you an extreme example. That's not the reality.

Q - Christopher Horvers {BIO 7499419 <GO>}

Thank you.

Operator

Your next question comes from the line of Mike Baker from D.A. Davidson. Your line is now open.

Q - Michael Baker {BIO 22286943 <GO>}

Okay. Thanks. I guess, I'll stay on the inflation question, but ask two different inflation questions. One, if prices do come down, eventually they will, historically, what do you see in terms of your ability to maintain the current prices? In other words, not to come down and then to gain some margin in sense.

And then second inflation related question, historically, when you see outside is inflation now, it's been a long time since we've seen inflation like this, but you've been around for a long time. When you see inflation, do you get more customers coming into to Costco to save money? You alluded to that earlier; you said that's what you hope happens. But I guess, I'm sure you've looked at it historically, what have you seen?

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

On the latter question, past history is indicated, yes, not in a big way, but the answer is yes, directionally. As it relates to prices come down, if our costs come down, we want to be the first to lower the price, period.

Q - Michael Baker {BIO 22286943 <GO>}

That makes sense. One last one if I could; similar to the -- to get more customers one is an inflationary environment, do you see more customers wanting to sign up to take advantage of your value in any tougher economic situation, in other words in 2022? No stimulus does appear as if you know the economy might not be always a consumer economy might not be as strong as last year. How does that impact your memberships or renewal rates? Thanks.

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

You've asked us two years ago, how would the next two years be in terms of new members sign ups? We would be positive, but we probably have achieved greater than those -- than our own expectations by a little. And so, arguably that it was not just the stimulus, but notwithstanding the stimulus, there was a lot of positive feelings out there in terms of a consumer and we did just fine.

So, one of the good things that we've been blessed with that and we are the extreme value proposition and it generally bodes well for us in good and bad economic times. And so, I think we don't pay a lot of attention to it other than seeing -- really being focused on driving price and value of our products and services and taking care of the customer and then the rest seems to work.

Q - Michael Baker {BIO 22286943 <GO>}

Yep. Sure, it does. Thanks for the color.

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

Yes, sir.

Operator

Your next question comes from the line of Rupesh Parikh from Oppenheimer. Your line is now open.

Q - Rupesh Parikh {BIO 22151706 <GO>}

Good afternoon. Thanks for taking my questions. So, I had a question just on the labor front, I was just curious what you guys are seeing from a labor availability standpoint? And then, what your comfort is with your wage levels in the marketplace just given we -- others raise the wages.

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

Well, we continue to raise them as others have and we will continue to do that. The biggest single area of challenge is, one, we're headquartered in Seattle, which is an -- has become an increasingly expensive market and within that, IT, where you not only have too big behemoth, tech behemoths, but the next three tech behemoths all have 10,000 to 20,000 employees in this town as well. So, we've had a raise wages there and didn't happen overnight in the last two weeks. It's happened continually over the last couple of years, and we will also lose a few people, because we're not 100% work from home.

We have a -- we think a good, fair, hybrid work model, but for some few they want that. Overall though, if you look at our total compensation and benefits package, 90% of our employees are hourly in the warehouse. And we -- while maybe there's a city or two, where we've got a occasionally start it one step above the entry level, we've continued to raise the wages as I mentioned in the thing and we'll do it again.

Q - Michael Baker {BIO 22286943 <GO>}

Okay, great. And maybe one additional question; just on the ancillary front, if you can just remind us where you are with your recovery versus pre-pandemic and some of the more challenged categories, travel, food, et cetera.

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

Yes. Well, the biggest one is, gas and that's gone nothing, but up. And again, as I mentioned earlier, the retail competitive price pressure is probably lessened over the last couple of years. Travel, you mentioned is one that has -- been extreme ups and downs. There was a period during the mid-2020 year lockouts, COVID lockouts, where we had negative -- we lost money and the business and had negative revenues, because you're getting more cancellations and no new orders.

And that fluctuates. It's come back, it fell a little bit with Delta. It came back after that. It fell a little bit with Omicron. Although now we seem to be up on the upward trend and it is profitable not as profitable as was two years ago, but continue in that direction, huge business and both vacation packages as well as auto-rental cars and the like. So, that's a business that's going nicely. It was businesses like where there's face-to-face touch if you will with in our hearing aid and optical shops that was actually closed for a number of weeks in the mid-2020, but just for a 10 or 15 weeks, I think, that's come back as well. Food courts have come back, because we have chairs and tables back out and we expanded the menu. So, overall, a few of those ancillary business, they're not back to where they were, but they're getting there. And then, of course, the one business that dwarfs all, the other is gas just in that size and its increased profitably. So, overall ancillary is doing fine and some of the ones that were hurt the most are picking up.

Q - Rupesh Parikh {BIO 22151706 <GO>}

Great. Thank you.

Operator

Your next question comes from the line of Kelly Bania from BMO Capital. Your line is now open.

Q - Kelly Bania {BIO 16685675 <GO>}

Hi. Thanks for taking our questions. Just follow-up real quickly on the gas. Richard, you made the comment about gas margins going up kind of across the space. Can you help us understand a little bit about how Costco's gas margins are relative to 2019? Are they up, maybe just up a little less and where are we with gallons versus 2019?

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

I don't have that detail in front of me. Margins are up, prices are up, and it's a huge business. It's a little more than 10% of our sales. It's $20 million plus business now recognizing there's been a -- what, as I mentioned earlier, 30% plus increase in just a price per gallon. But it's definitely been up the last couple of years. It is less volatile than it was five and ten years ago in terms of big margin, fluctuation, but I don't have the detail related to years ago.

Q - Kelly Bania {BIO 16685675 <GO>}

Okay. I'll just ask another one just on white space then just in the U.S. Just curious if you can just give us an update on how you're looking at that today over the next couple years. Do you have to at all change your target demographics or target population density in terms of where you'll plan on opening up new clubs in the U.S. --

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

Sure.

Q - Kelly Bania {BIO 16685675 <GO>}

-- the eventual number that you see, just an update there?

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

Sure. I mean, if you'd asked me five years ago how many -- five years hence or now how many -- would look like, five years ago, we were opening about 25 a year, call it 26 to make the math easy for a second. And maybe 70/30 U.S. and Canada are most successful mature, most mature markets. And that over the next 5 or 10 years, the 70/30 would probably go to 60/40 outside of the U.S. and Canada.

And here we are five years into this -- that incorrect answer, and we're putting this 65/35 U.S.-Canada for two reasons. Partly is, is our expectations of what we can do in the U.S. and Canada has increased not just in the last five years, but in general, over many years and it's taken a little longer, the timelines internationally although we've got more feet on the ground and more stuff looking. So, if you ask me today and look five years from now, we'll go from 65/35 or whatever X is today probably down to 50/50. And even good news with that answer from that perspective is, is that we feel, we still have plenty of opportunities in the U.S. and Canada.

And we've ramped up our activities to do more in these other countries, where we've also been quite successful. The -- if you -- asked over the next 10 years, we're opening, I think this year 16 of our 28 or in the U.S. that could be up by one or two, our view is, there's no reason to think for the next 10 years, we can open 15 or so a year in the U.S. Now mind you, one or two of those or growing to two or three will be the business centers. We now have 22 business centers in the U.S. and five in Canada, that's been a good adjunct to our business, but we're also -- and we're infilling. I gave an example at an internal meeting yesterday and I've given it before to you guys in San Jose about four or five years ago, we opened our fourth in the greater San Jose market.

At the time, the three units we're doing about 250 each, now, the four units are averaging right at 300 each averaging. And on fewer members per location, because you got existing members driving less far. So, there's a combination of infill. Now, we're in 46 states, so there's not a lot of additional states. We're less penetrated versus our direct competitors in certain locations in the Midwest and Texas, South -- and parts of the Southeast, and we're still opening there as well. So, it's really is a combination of all those things. I think our view is -- the good news is that there's still -- we're far from saturating our most saturated markets and we've upped the ante in terms of feet on the ground, real estate feet on the ground, if you will, in terms of getting some more -- more into the pipeline.

Q - Kelly Bania {BIO 16685675 <GO>}

Thank you.

Operator

Your next question comes from the line of John Heinbockel from Guggenheim. Your line is open.

Q - John Heinbockel {BIO 1508150 <GO>}

Hey, Richard. First thing philosophically, how do you guys think about closing the gap on the two membership tiers, right, maybe encouraging some further conversion to executive? And I don't know if you've done any kind of work with your current executive members. What would they like in the membership that's not there today, right, and perhaps might just -- it might help you take the monthly -- the annual fee higher?

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

Yes. I don't know exactly. We would ask -- I need to ask our membership marketing people. I think we've frankly been very pleased of our success of getting more existed -- more new members, more existing members to convert. And frankly more new members to sign up initially as an executive. Mind you, 8 or 10 years ago, in the U.S., where it started, we've had it for 15 years now probably. You came in and we just signed you up. We asked you what you wanted. We didn't do a lot and maybe 20 or 25 at most 25 of every 100 signed up as an executive member.

Today, it's in the 50s, closing -- and close to 60, and that's what just trying in a little bit and showing them the value of it. So, I think we've done a better job of doing that. We do a better job when we go into a new country. We're now in I think five of our -- six of our countries, which are the largest ones. You want to have at least 15 or so locations before you're looking at it to put an executive membership in it. So, we've toyed with the idea of having something even higher than the executive, but we always go back to the fact that what we have works very well. And so, I don't think there's anything currently on our plate to change that. We're always -- we've also asked the question at some point right now, it's 72% or 73% of our sales over the executive member. What happens when it gets to 85% or 90%. Do you eliminate the lower membership? At some point, we might, but that's again not in the cards any time in the near future. We kind of like the what we're doing and it's working fine.

Q - John Heinbockel {BIO 1508150 <GO>}

And secondly, where are you on the personalization journey? I know you hired somebody maybe two years ago to kind of spearhead that. Where are we? And does that pick up steam in the next year or so?

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

I think it picks up steam in the next year or so. The first order of business, when we brought in people on that data analytics side two years ago, a person, we -- he has built a great team and I've -- we've seen small deliverables first and foremost not online, but with the merchants, and to a smaller extent, with some of the operators, and there's been some real deliverables that have saved our buyers time and those are in the process of being rolled out. On the personalization and targeting, I think we've got a little better targeting and that -- and still have a journey on the personalization, but that will be coming, but I thank you for asking it when you said a year or two.

Q - John Heinbockel {BIO 1508150 <GO>}

Okay. Thank you.

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

We'll take two more questions.

Operator

Okay. Note that, sir. Your next question comes from the line of Laura Champine from Loop Capital. Your line is now open.

Q - Laura Champine {BIO 4748805 <GO>}

Thanks for taking my question. I will make it quick. It's a follow on to the unit growth questions asked earlier, but it sounds like you are positioning the business to launch more international stores. Is it -- does it make sense for me to interpret that as unit growth may accelerate next fiscal year and beyond from this looks like it's going to be about 3.5% this year.

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

Look, our goal for the last several years, there was the unique year of COVID, where we went down to 13 openings, because there were several that construction had stopped for several months in the middle of 2020. But the reality is, if you go back five or six years, we were opening 25%-ish, some years 21% or 22%-ish, and the view even then was is to get up to closer to 30%, certainly 25% to 30%. I think this year is we're finally hitting that with the expectation of 28% in my call this morning and call it 26% to 30%, whatever excess it comes out to be.

And we would certainly be comfortable at 30%. One of the things that is unique is we try to be relatively methodical about it, particularly in new international markets. Once you open the first one, if it's successful year, you're taking some people from that one to help and succeed in opening the second one. One of the things is it's -- the biggest cost factor on warehouse P&L is labor and efficiency. And when you're running a high volume unit, it's helpful when you've got more people coming over from a nearby unit.

So, we are pretty methodical about growing somewhat slowly in new markets. We went from 1 to 5 20 years ago over a 5-year period in Japan. We've sped up a little in China thinking that we've opened two now in three years and with another several in process, probably several is more than a couple more. So, we've increased it a little bit, and -- but we feel pretty good about that. So, I would still say, our rounded pat answer right now is

25% to 30%, and we'd like it to be more into the 30% than 25% right now. But we're not necessarily looking at that percentage. As we get bigger, God willing in year 6 through 10, we're going to be talking about 30% to 35%, but we'll have to wait and see.

Q - Laura Champine {BIO 4748805 <GO>}

Got it. Thank you.

Operator

Your last question comes from the line of Peter Benedict from Baird. Your line is now open. Peter Benedict, your line is now open.

Q - Peter Benedict {BIO 3350921 <GO>}

Sorry, take me off mute there. Thank you, Richard. So, my questions have been asked, but the -- yeah, just thinking about the supply chain situation, and just curious if it's caused you guys to rethink or accelerate any of your kind of sourcing initiatives. I mean, you talked about the vessels in the containers and that clearly seems to be in reaction to what's going on. But I'm thinking more along the lines of categories, these efforts you've been underway for a long-time going vertical. Are there any that maybe have jumped to the front of the line, because of what you've seen over the last year or two?

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

Well, I think a couple of things we have done not in a big way, but a couple of things we have done is there probably a little bit diversification of suppliers particularly on huge $300 million to $1 billion SKUs. You need a little bit more there. We've brought in certain things non-traditional to its season during the winter bringing in bikes, because we could have access to them and we sold them. Yes, new countries of origin. So, there's a few of those things, but not in a big way. Part of our success is huge buying power per item and having less than 4,000 SKUs to do our $200 billion. It's quite a bit different than having even 100,000 SKUs doing $150 billion to $500 billion depending on who the retailer is. So, we've made changes and we are more open-minded to bring in some things, but hopefully, this thing, the supply chain works out over the next couple of years in a big way and a better way.

Q - Peter Benedict {BIO 3350921 <GO>}

Sure. And then just lastly, I've studied the executive membership 43% of the members and 70% of the sales. How -- where are those numbers and maybe your more established markets where you've had it? And maybe how under penetrated is it in some of the newer markets? Just trying to get a sense of what the pathway might be for some of these newer markets.

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

Yes. Well, it's like renewal rates. Renewal rates irrespective of what it becomes 10 years hence in a location and in a market, it starts off at a lower number and builds up to the higher number. Same thing with that executive transition. We're doing better today and even in first-year new market. So, I think in the last couple of years, where we added executive Japan and Korea. And yeah, I mean, that 42% number is hovering in the low-50s, 50 or a little higher and more mature markets, and starts off lowering in other markets. But higher than it started in the previous new market a few years ago. So, it grows over time.

Q - Peter Benedict {BIO 3350921 <GO>}

Fair enough. Yes.

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

Well, thank you very much. Everyone have a good afternoon and evening, and I appreciate you getting on the call.

Operator

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