Q3 2022 Earnings Call

Company Participants

- Robert Nelson, Senior Vice President, Treasury, Financial Planning and Investor Relations

Other Participants

- Brandon Cheatham, Analyst
- Chuck Grom, Analyst
- Edward Kelly, Analyst
- Erica Eiler, Analyst
- Greg Melich, Analyst
- John Heinbockel, Analyst
- Karen Short, Analyst
- Kelly Bania, Analyst
- Laura Champine, Analyst
- Megan Alexander, Analyst
- Peter Benedict, Analyst
- Scot Ciccarelli, Analyst
- Simeon Gutman, Analyst
- Unidentified Participant

Presentation

Operator

Good day and thank you for standing-by. Welcome to the Costco Wholesale Corporation Third Quarter Earnings Conference Call. 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) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker for today. Thank you. Please go ahead.

Robert Nelson {BIO 19296866 <GO>}

Thank you, Erica and good afternoon, everyone. This is Bob Nelson, Senior VP of Finance and Investor Relations here at Costco. Thank you for dialing in today into today's conference call to review our third quarter fiscal year '22 operating results. Before we begin, a couple of housekeeping items to take care of. First, as you now have surmised, Richard is not with us today. He is doing great and wishes he could be on the call. He is in Italy with this family on a rescheduled vacation that was canceled early in the pandemic.

He wanted me to pass along his best to everyone and in his absence, I will be filling in for him today. Secondly, and before we get into the details of today's earnings results, I need to read our Safe Harbor disclosure. Let's begin.

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 our 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. Okay. With that out of the way, let's get to it.

In today's press release, we reported operating results for the third quarter of fiscal '22, the 12 weeks ended this past May 8. Net income for the quarter was $1.353 billion [ph] and $3.04 per diluted share. The reported $3.04 included a one-time $77 million pretax charge $0.13 per diluted share for incremental benefits awarded under the new employee agreement, effective this past March 14.

Last year's third quarter net income was $1.22 billion $2.75 [ph] per diluted share, which included $57 million pre-tax or $0.09 per diluted share for costs incurred primarily from COVID-19 premium wages. In terms of this year's $77 million pretax charge, this was in conjunction with our new employee agreement, again effective this past March 14 and was primarily to adjust our benefit accrual to account for one additional day of vacation which is awarded to each employee immediately.

The continuing impacts of the wage and benefit enhancements reflected in SG&A and margin for this quarter and will be in enforced as well as for subsequent quarters. Net income for the first 36 weeks of fiscal '22 was $3.98 million [ph], $8.94 per diluted share and that compares to $3.34 billion or $7.51 per diluted share last year.

Now -- let's now review the metrics of our P&L. As always, starting with sales. Net sales for the third quarter increased 16.3% to $51.61 billion and that compares to $44.38 billion reported last year in Q3. In terms of comparable sales for the third quarter for the 12 weeks on a reported basis, the US was better or up by 16.6%, Canada better by 15.2%, other international up 5.7% and total company again up 14.9%. Our e-com business in the third quarter reported better by 7.4% versus year ago.

For the 12 weeks excluding the benefit of gas inflation and the headwinds of FX, the US came in at up 10.7%, Canada better by 12.8%, other international up 9.1% and on a total company reported basis, ex gas inflation and FX headwinds better by 10.8%. And e-commerce just below 8% at 7.9% for the quarter.

In terms of Q3 comp metrics traffic or shopping frequency increased 6.8% worldwide, and up 5.6% in the US. Our average transaction was up 7.6% worldwide, and up 10.4% in the US during the quarter, and foreign currencies relative to the US dollar negatively impacted sales by just a little over 1% and our gasoline price inflation positively impacted sales in the quarter just a little bit more than 5%.

The best performing categories in Q3 were candy, sundries, tires, toys, jewelry, kiosk, home furnishings, apparel, bakery, and deli. Underperforming departments were liquor, office, sporting goods, and hardware. All of which were quite strong a year ago. In terms of other business sales, the best performers came in from gasoline, travel, food courts and our business centers. So, overall our sales grew nicely in the quarter and for the most part, we're pretty broad based.

Moving down, the income statement to membership fee income reported in Q3 $984 million or 1.91 as a percentage of sales compared to last year's $901 million or 2.03 as a percentage of sales. That's up $83 million year-over-year or a 9.2% increase and excluding headwinds from FX of about $10.6 million, membership was up 10.4% in the quarter.

In terms of renewal rates, we hit an all-time -- we hit all time highs at Q3 end. Our US and Canada renewal rate was 92.3% up three tenth of a percent from the 12 weeks earlier at Q2 end and the worldwide rate came in at 90% for the first time in company history and that's up four tenth of a percent from what we reported at Q2 end. Renewal rates continue to benefit from the increased penetration of both auto-renewals and more executive members. And then in addition to that higher first year member renewal rates than what we've historically seen.

In terms of member counts, number of member households and cardholders at Q3 end, we ended Q3 with $64.4 million paid households and 116.6 million cardholders both of those up over 6% compared to a year ago. At Q3 end, our paid executive memberships were 27.9 million and that's an increase of just about 800,000 during the 12 weeks since Q2 end.

Executive members now represent over 43% of our member base and over 71% of our worldwide sales. Now, before I move on, I want to take just a minute and address the question that we've been getting a lot recently regarding the timing of the potential membership fee increase.

Historically, we've raised fees every 5 years to 6 years with the last three increases coming on average at about the 5.5 year timeframe. And our last increase coming in June of 2017. As we approach this 5.5-year mark, there will be more discussions with Craig, Ron and the executive team, but for today, we have nothing more specific to report in terms of timing.

In addition, given the current macro environment, the historically high inflation and the burden it's having on our members and all consumers in general, we think increasing our membership fee today ahead of our typical timing is not the right time. We will let you know however, when that changes.

Okay. Moving on, along the P&L. Let's take a look at gross margins. Our reported gross margins in the third quarter were lower year-over-year by 99 basis points. This year coming in at 10.19 as a percentage of sales and that compares to last year's 11.18 that we reported a year ago.

So the 99 basis points down year-over-year and excluding the negative impact of gas inflation, we would have been down 53 basis points. So if you would for me and as normal please jot down the following for our gross margin matrix. And again as usual two columns, the first column being reported gross margin. The second column being gross margin without the impact of gas inflation.

There are six rows, the first row being merchandise core. Second, ancillary and other business. The third row, 2% rewards followed by LIFO, other and then total. So in terms of our core merchandise margins on a reported basis, they were down 87 basis points versus last year, down 46 basis points, ex-gas, ancillary and other plus 6 reported and plus 18 ex-gas, 2% reward plus 8 and plus 3, LIFO minus 25 basis points on a reported basis and minus 27 ex-gas inflation.

And finally, other minus 1 with and without gas. So, again, in total, down 99 reported down 53 excluding the impact of gas inflation. A little color -- more color on gross margins, starting with core merchandise. The core merchandise contribution to gross margin was lower by 46 basis points, ex-gas inflation in the quarter. Sales mix negatively impacted the quarter primarily from the lower sales penetration of total core sales relative to our gasoline sales, which were very strong in the quarter.

In terms of the core margins on their own sales in Q3, our core-on-core margins were lower by 39 basis points. Approximately two thirds of this coming from fresh foods. Fresh experienced a very difficult compare versus last year when the extraordinary volumes produced -- extraordinary volumes produced lower D&D and higher labor productivity. a year ago.

Also contributing to the fresh decline this quarter were raw -- higher raw material costs and higher labor costs due to our new wages. Ancillary and other business gross margin, again higher by 6 reported, higher by 18 basis points, ex-gas inflation. Gas, travel and business centers were better year-over-year, offset somewhat by e-com, pharmacy and optical.

Again 2% rewards higher by 8 [ph] reported higher by 3 ex-gas, LIFO minus 25 and minus 27 ex-gas as we recorded a $130 million charge in the quarter for LIFO and other was minus 1 basis point both with and ex-gas inflation. This included items from both years. Last year, we had $14 million of COVID expenses primarily premium wages within gross margin. This year, we had a one-time charge discussed at the beginning of the call, the $20 million of the $77 million of which related to gross margin.

The net result of these two items again minus 1 basis point. And while we continue to mitigate the impact of price increases as best as we can, we remain comfortable in our ability to pass through higher costs while providing great value to our members. Moving to SG&A, we show good results. Our reported SG&A in the third quarter was lower or better year-over-year by 84 basis points coming in at 8.62% and that compares to last year's reported 9.46% SG&A figure that's again 84 basis points lower or better and 44 basis points, excluding the impact of gas inflation.

Again if you jot down the following for SG&A matrix, again two columns, the first column being reported SG&A. The second column SG&A ex the impact of gas inflation. And we have five rows. The first row operations, second row central, third row, stock compensation expense, third -- our four row other and then total is the fifth row.

In terms of our operations on a reported basis, SG&A was better by 68 basis points. And, ex the benefit of gas inflation better by 35, central better by 15 reported better by 10 ex-gas, stock compensation better by 2 reported better by one ex gas and, other minus 1 and minus 2 ex-gas again all total 84 [ph] basis points lower or better and 44 excluding the benefit of gas inflation.

In Q3, year-over-year, the core operations component of SG&A was better by 68 again 35 ex-gas. Keep in mind this result includes the starting wage increase we instituted this past October as well as 8 weeks of the new wage and benefit increases just implemented during Q3 on October 14 of this year. Central was better by 15 and better by 10 without gas, stock comp plus 2 plus one without gas and again other minus 1 basis point, minus 2 without gas inflation. Similar to gross margin, this included items from both years. Last year we had 44 million of COVID expenses and this year, we had a one-time charge again discussed at the beginning of the call, $57 million of the $77 million which related to SG&A.

The net result of these two items again minus 1 reported, minus 2 ex-gas inflation. So all told, reported operating income in Q3 of this year increased 8% coming in at $1.791 billion. Below the operating income line, interest expense was $35 million this year versus $40 million last year and interest income and other for the quarter was higher by 44 basis points year-over-year primarily due to favorable FX.

Overall pretax profit -- pretax income came in for the quarter, up 11% coming in at 1.827 billion, and that compares to 1.65 billion, which we reported a year ago. In terms of income taxes, our tax rate in Q3 was 24.9%. That compares to 25.2% in Q3 last year. Overall for the year, our effective tax rate is currently projected to be between 26% and 27%.

A few other items of note, warehouse expansion in Q3, we opened one net new warehouse plus two relocations. Q3 year-to-date we have opened 17 warehouses, including three relocations for a net of 14 new warehouses so far this fiscal year. For the remainder of the fiscal year and in Q4, we expect to open an additional 10 new warehouses, which will put us at 27 for the year, including three relocations and for a net of 24 net new warehouses for all of fiscal year '22. The 24 new warehouses by market are 14 in the US, two in Canada and one each in Korea, Japan, Australia, Mexico, Spain, France, China and our first opening in New Zealand, which will occur in August of this year.

In terms of the new openings this year, this is far fewer than what we projected in Q2. two of the four were impacted by supply chain issues related to electrical equipment and the other two have been delayed due to third party site development issues. All four of these buildings are now scheduled to open by the end of calendar November this fall.

Incidentally, there are three in the US and one in Australia that were delayed. The one net new opening in Q3 was a Business Center located in San Marcos, California and the first is the ten scheduled to open in Q4, opened this past week in Riverton, Utah bringing our worldwide total to 830 Costcos as of today and around the world.

Regarding CapEx, the Q3 '22 spend was approximately $854 million. Our full year CapEx spend is estimated for the year to be just shy of about $4 billion. In terms of our e-com business. E-com sales in Q3 ex-FX increased 7.9%. This is on top of the 38% increase a year ago. Stronger departments in the quarter were special order, patio and garden jewelry and home furnishings. Our largest e-com merchandise department majors which includes consumer electronics, appliances, TVs was up a little bit better than mid single digits on a very strong sales increase, a year earlier, and Costco grocery including our third party delivery 2-day dry fresh and frozen continues to grow up low double digits in the quarter.

An update on Costco Logistics. Costco Logistics continues to drive big and bulky sales for us. We average more than 58,000 staffs a week in the third quarter. For the full year, we estimate total deliveries will get 23% and will exceed 3 million. Cost -- with logistics, we continue to transition from vendor drop ship to direct ship from our own inventory particularly in big and bulky items, overall this lowers the cost of merchandise and improves delivery times and service levels for our members.

Okay a few -- now a few comments regarding inflation. First of all, it continues, pressures from higher commodity prices, higher wages, higher transportation costs and supply chain disruptions all still in play. For Q1, we estimated price inflation was in the 4.5% to 5% range. For Q2, we had estimated 6-ish percent if you will, and for Q3 and talking to our merchants, estimated price inflation was in the 7-ish percent range. However, we did see inflation in fresh foods come in slightly lower in Q3 versus Q2 a year ago as we began cycling high meat prices. We believe our solid sales increases and relatively consistent margins show that we have continued to strike the right balance in passing on higher costs. Switching over to inventory for a minute.

Our total inventory in Q3 was up 26% year-over-year versus up 19% in Q2. A couple of high-level comments regarding inventory, a material component of the increase year-over-year is inflation rather than unit growth. We continue to expand, open new locations, 20 new in the last 12 months. We are lapping some low stocks in certain departments as a result of last year's high demand and we are purposely building inventory in our e-com business primarily in big and bulky categories as mentioned earlier in the call.

Food and sundries and fresh is in very good shape. Our weak supply is comparable year-over-year. Non-food inventories are up in certain categories, this is in part a result of being light in certain departments last year specifically seasonal lawn and garden, TVs, appliances, and sporting goods. Otherwise, we are a little heavy in small appliances and domestics, primarily due to late arriving merchandise this year.

In addition, we have a few hundred million dollars of extra inventory in both late arriving holiday merchandise from last season, which we're storing until this fall and some buying merchandise to ensure proper inventory levels in the face of these ongoing supply chain issues. Speaking with Craig, Ron and Claudine Adamo, our new head of merchandising, we feel good about our current inventory levels.

The additional inventory we're carrying in the right departments and they [ph] feel good about our ability to move it. A quick update on China. Our first opening in China located in Minhang, Shanghai was closed for the last 6 weeks of the third quarter. That closure had a negative impact in the quarter of approximately $35 million in sales. As of May 18, we're happy to report that building is back open, but operating under restrictions on the number of people that can be in the building at one time among other cleaning and operating restrictions. Our second building in Suzhou, which opened in December of this last December, it was largely -- has largely avoided the lockdowns and restrictions to this point.

We are currently targeting an opening date of this December for our third Shanghai building in Pudong, the timing, although will somewhat depend on the area remaining open for the next several months and not being more negatively impacted by lockdowns. Four additional China buildings are currently underway and planned with opening dates in the next two years.

These would be our first China openings outside of Shanghai. I believe, we have of those four one is in fiscal '23 and three in fiscal '24. As a reminder, in terms of upcoming releases, we will announce our May sales results for the four weeks ending Sunday May 29 this next week on Thursday, June 2 after market close. This is a day later than our traditional Wednesday release due to the Memorial Day holiday.

Before wrapping up, a quick shout out to the 300,000 worldwide Costco employees around the globe and the excellent work and proactive effort they give each day to navigate during these most challenging environment. Our merchants and operators are the best in the business and their hard work is reflected in our strong operating results.

Finally, I want to address an incorrect information floating around on social media and a few other media outlets, claiming that we have increased the price of our $1.50 hot dog and soda combination sold in our food courts. Let me just say, the price when we introduced the hotdog soda combo in the mid '80s was $1.50, the price today is $1.50 and we have no plans to increase the price at this time.

With that I will turn it back over to Erica and open it up for Q&A. Thank you.

Questions And Answers

Operator

(Operator Instructions) Your first question comes from the line of Simeon Gutman with Morgan Stanley.

Q - Simeon Gutman {BIO 7528320 <GO>}

Hey Bob, how you doing?

A - Robert Nelson {BIO 19296866 <GO>}

Good.

Q - Simeon Gutman {BIO 7528320 <GO>}

Who is going to whisper the answers if you are the one doing all the talk.

A - Robert Nelson {BIO 19296866 <GO>}

I got Ron [ph].

Q - Simeon Gutman {BIO 7528320 <GO>}

Okay I hear it. Can you tell me, on the core-on-core margin ex gas, it looks like underlying run rate got a little worse, which I don't think is a big surprise given what we're hearing out there. You mentioned in the core-on-core the perishable year-over-year, but is it safe that is it transport or is it -- there are some markdowns on erratic inventory coming in? Can you talk a little about what's happening there? Thanks.

A - Robert Nelson {BIO 19296866 <GO>}

Yeah, on the fresh side, we literally had no D&D last year and we had very high labor productivity because of the times [ph] that we were going -- that we were -- that we are processing, if you will. So I think, we've kept a lot of that leverage actually. We're way above pre-pandemic levels. It's just it was extraordinary last year. So -- and I think, we'll keep some of that, but it's not all that and then a little bit of it is like I said, raw material cost this year. I mean those eventually make their way into our -- the price of our goods, but as you know, we're not the first one to go up when we have higher costs.

I think just recently, it may have been after the end of the quarter, we reluctantly but we took up the price of our muffins and our croissants, I think $1 as the price of a lot of those raw materials have continued to escalate to two and three and four times what they were last year. So that's essentially what's going on there.

Q - Simeon Gutman {BIO 7528320 <GO>}

Got it. Maybe my follow-up, is anything happening on trip consolidation items, per trip rising, anything that I'm sure this is a question you're ready for?

A - Robert Nelson {BIO 19296866 <GO>}

Yeah, honestly we're not seeing a lot of change in our throughput in the buildings. I mean, we're seeing a lot of traffic. We're not seeing a lot of -- we're not seeing trade down, really. We're seeing a little bit of shift in where people are spending their money Last year, there was more stuff in the home and that -- and this year, it's more sales in tickets and restaurants and travel and tires and gas and things of that nature, but we're still holding our own in areas like apparel and furniture and jewelry, TVs and appliances, all those departments are showing good -- decent sales growth on top of pretty good numbers a year ago.

I would say overall, there might be a very small amount in terms of the number of items in the basket this year, a little less than last year because there was more trip consolidation going on a year ago. I think during COVID, but overall, I think we feel pretty good about what we're seeing and how our members are shopping.

Q - Simeon Gutman {BIO 7528320 <GO>}

Okay. Thanks, Bob. Take care.

Operator

Your next question comes from the line of Chuck Grom with Gordon Haskett.

Q - Chuck Grom {BIO 3937478 <GO>}

Okay, thanks a lot. Good job, Bob today. Just curious, Craig's view on balancing the desire to show value particularly lately as the macro backdrop continues to get more uncertain. We'll also passing on some price increases, like you articulated in placing up anywhere between 5% to 7% but we know in some cases the pressures are much higher. So just curious where Craig is on that balance?

A - Robert Nelson {BIO 19296866 <GO>}

Well, look, I think we always want to be the best value in the marketplace and to the extent that we continue to show that. I think, it's easier for us to pass on higher pricing or higher freight costs or raw material costs assuming that we show that value in the marketplace. And that's what it's all about really and I think, we feel good about it.

I mean, our most recent shops against who we watch most closely have not changed and we are every bit as competitive as we've been, notwithstanding the fact we have taken some prices up in certain areas in food and sundries and in fresh foods.

Q - Chuck Grom {BIO 3937478 <GO>}

Okay, great. And then on the core on core, you talked about two thirds being fresh, just wonder if you could just give us some color on some of the discretionary categories?

A - Robert Nelson {BIO 19296866 <GO>}

Well, I think that the balance was slightly more in non-foods than in foods in terms of the remaining third of the lower margins. I'm not sure I have specifics right now on certain specific categories. I mean, again, it's not really a category. We are an item business and so it's all about certain items where we might move or not move.

Q - Chuck Grom {BIO 3937478 <GO>}

Okay, cool. Thanks, Bob.

A - Robert Nelson {BIO 19296866 <GO>}

Thanks, Chuck.

Operator

Your next question comes from the line of Christopher Horvers with JP Morgan.

Q - Megan Alexander {BIO 19910123 <GO>}

Hi, thanks very much. This is Megan Alexander on for Chris. Maybe a follow-up to Simeon's question, are you seeing any pressure from rising fuel and diesel with regards to transportation in that core on core and if so, it seems like they accelerated pretty quickly at the end of April, are you holding back any of the price increases on those costs, such that it's impacting core on core maybe more than normal?

A - Robert Nelson {BIO 19296866 <GO>}

No, I don't believe so, Megan. I mean that -- I think overall there's higher transportation costs across the whole supply chain whether it's ocean freight or trucking or the price of fuel, et cetera, et cetera. I think eventually those costs make their way into your sell price. Again, it's not like anything else, we tend to drag a little bit compared to others.

But I don't think, there is material change since the end of April in terms of how we're managing that.

Q - Megan Alexander {BIO 19910123 <GO>}

Got it. Okay, that's helpful. And then maybe just a quick follow-up on LIFO, since price increases have continued, it seems does that pressure continue to accelerate going forward? And then do we ever kind of get that back as we lap or does it depend on what the cost environment looks like?

A - Robert Nelson {BIO 19296866 <GO>}

Yes, well it certainly can't be predicted and tell you exactly where it's going. We've obviously seen more inflation as the years progressed. If we stay at this level, there will continue to be some impacts to our P&L, if we start to see deflation, if we were in an inflationary environment next year, yes, we would get some of that back, but we got our ways to go. I think everybody thinks we're still in this cycle of more inflation versus it stopping.

Now, to be fair, this is the first time when we get into Q4 that will actually start cycling some at the beginning of this last year and I think, we had a small LIFO charge in Q4 a year ago. So I'm not predicting, but we saw a little bit of decline in our fresh food inflation this past quarter. What we see some -- in other areas as we enter Q4, maybe, but that could be offset by higher costs in other areas in the supply chain.

So, and then of course that higher level inflation started hitting us in Q1 and Q2 of the beginning of this year. So I really can't predict where it's going to go, but assuming we get more inflation, we will have more LIFO charges to the extent that reverses at some point, we'll get some credits.

Q - Megan Alexander {BIO 19910123 <GO>}

Got it. Thank you very much.

A - Robert Nelson {BIO 19296866 <GO>}

Sure.

Operator

Your next question comes from the line of Scot Ciccarelli with Truist Securities.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Hi Bob, how are you?

A - Robert Nelson {BIO 19296866 <GO>}

Good.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Good. I guess more of a business strategy question, if you will. Good impact from pretty good SG&A leverage, which helped offset the merch margin compression that you saw. I guess the question is, would you try to pass on more price increases to protect your gross margin, if you didn't think you'd have as much SG&A leverage as you were able to generate?

A - Robert Nelson {BIO 19296866 <GO>}

That's a hard one to answer. Look, it's all -- look we would never raise prices if we could get SG&A leverage in every single quarter from now until eternity. I mean, our goal would be to lower prices indefinitely and lower SG&A. It's all a balancing act, sure. The same can be said on gross margins. I mean everybody has read what's going on out there in the industry, our sales and gas were very strong. Our gross margins were strong and to the extent we're able to lever that into other areas of the business by holding prices. That's what we do. That's retail.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Got it, okay. Thank you.

Operator

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

Q - John Heinbockel {BIO 1508150 <GO>}

Hey Bob, I want to start with, because we're in unchartered territory here with inflation in recent times, to what degree do you guys (technical difficulty) do much of this but test, We're going to take pricing up in certain places to see what the consumer reaction is and then go more broadly. And have you seen any item-by-item any elasticity where you'd say okay, we're not going to roll it out or rollup the price increase or roll it back?

A - Robert Nelson {BIO 19296866 <GO>}

Yeah, John, honestly we don't, we don't really test markets or we won't take a market like Seattle and test taking a price beyond our comfort level. It all comes down to value proposition. And if we feel like we can take a price up and pass on some of the costs that we're incurring in our goods and the value proposition is still there, we will go there.

We're not testing all these items across the space.

Q - John Heinbockel {BIO 1508150 <GO>}

Okay.

A - Robert Nelson {BIO 19296866 <GO>}

I mean it is unprecedented times. I will tell you that because of our limited SKU counts and the small number of SKUs that each buyer actually manages. They have a pretty good understanding of where their competitive situation is in the marketplace and they have a pretty good feel about what kind of business they can do at what price. And I think that helps us in terms of managing that.

Q - John Heinbockel {BIO 1508150 <GO>}

Okay. And then maybe secondly, gas balanced, right. So what is that then up? And I guess historically, higher gas prices have translated into share gains for you? Are you starting to see that accelerate drive some incremental traffic to the books?

A - Robert Nelson {BIO 19296866 <GO>}

Well, that's a good question. Obviously, our value proposition in the marketplace is best in class and it's actually accelerated versus where it was a year ago. I think, the industry demand in gallons for gas is in the 1% to 2% range. And what I can tell you is we are much better than that in the high teens to low 20s in terms of where we've been trending. I will say, we're certainly getting a lot of shops in the building, when people buy gas, but given the extraordinarily high level. We're also getting a lot more members come by and top off their tank, just because the value proposition in some cases is over $1 a gallon and those members will come by and buy 5 or 6 gallons and then be on their way. So it's difficult to measure because of the -- just the huge amount of volume are getting through our stations right now.

Q - John Heinbockel {BIO 1508150 <GO>}

Okay, thank you.

A - Robert Nelson {BIO 19296866 <GO>}

Thank you.

Operator

Your next question comes from the line of Karen Short with Barclays.

Q - Karen Short {BIO 7215781 <GO>}

Hi, thanks very much. So two questions. Bob, obviously, you addressed the membership component that everyone has on their mind. But I guess, what I'm curious to hear from you is, I think you waivered in one direction then another direction like based on the last four months and so I'm curious to hear, why you are steadfast now that you would not raise the membership fee not that I necessarily think you should. But obviously, you've taken such stance. So that's my first question.

A - Robert Nelson {BIO 19296866 <GO>}

Well, I don't think we've really waivered. I think once we get a year out or a year and a half out from that 5.5-year cycle, we frankly just start to get a lot of questions about it. And the commentary in the prepared remarks is really more about just saying at this time, we don't think it's right for us. We're not saying that we're not going to do it. We're just saying it's not right for us right now and I think that's the same answer we had 3 months ago when we talked about it on the second quarter call. So I don't think anything's really changed, other than we're just not at the 5.5 year cycle yet. Does that make sense?

Q - Karen Short {BIO 7215781 <GO>}

Yeah, that makes sense. And then you made two comments just in terms of -- I think you said, you were a little heavy in small clients and holiday inventory, but you feel good about your ability to clear the inventory, so I just wanted to clarify, what exactly you mean on that in terms of preparing potentially for a slowdown with the consumer and/or if you're thinking there may be if you're not thinking there is and where you're at on that broadly?

A - Robert Nelson {BIO 19296866 <GO>}

Well, I can't tell you whether I think, there's going to be more pullback in a month or two months or three months. I mean, again, we feel really good about our ability to drive traffic and drive our members in. And frankly, the ability to drive the top line. When I spoke to Ron yesterday about this, look, he thinks that we've got a couple extra weeks supply in a couple of areas and he thinks, we can move through the inventory without really a lot of heartburn or problem. On the seasonal stuff, a lot of those is just Christmas stuff that came in late. We've got it in deep freeze and we're going to put it out this fall and we're probably going to put it out at pretty good values, because the price of lot of those stuff has gone up.

So we feel pretty good about being able to move that and then the other comment I made is just more inventory that we think makes sense to have like masks and things like that. So, where if there is some kind of hiccup in COVID, we're well prepared. So I don't want to say strategic, but it's -- you know, it's a little bit more inventory than we might typically carry and then kind of non- environment like we're in now.

Q - Karen Short {BIO 7215781 <GO>}

Okay, sorry, just to sneak one last one in. In terms of the fuel obviously that's a huge draw for you to your stores. Is there any update on the conversion into store during your open hours in terms of people filling up the tanks and then actually going into the store conversion, because I think that's historically been 70-ish percent during open hours?

A - Robert Nelson {BIO 19296866 <GO>}

No, no. That number has been like 50%. I'm not sure where 70% came from. That number has come down slightly and again because what I mentioned earlier, we have lot more members coming by and topping off their tank, but the overall number of shops from people buying gas is probably up, it's just the percentage is down because we have way more people going to the stations.

So the penetration is down a little bit, but the number of relative shops is up probably.

Q - Karen Short {BIO 7215781 <GO>}

Okay. I thought it was 70% during open hours and 50% overall. But maybe I was wrong, so, thank you.

Operator

Your next question comes from the line of Edward Kelly with Wells Fargo.

Q - Edward Kelly {BIO 21274619 <GO>}

Hi guys, good afternoon. I was hoping that maybe you could share some thoughts on the outlook for the gross margin in fiscal Q4, as we sort of think about some of the pieces. You know that year-over-year the core compare came off [ph] easier, but it's not really on a 2-year basis. It seems like you probably still going to have LIFO. I don't think fuel margins are off to a very good start at all, but I -- maybe that's just because gas prices are rising and obviously, it's a long quarter.

I'm just kind of curious is that like the expectation that we should have around the current quarter?

A - Robert Nelson {BIO 19296866 <GO>}

Yeah, and I wish I could be more transparent about what our budgets are everything, but we really don't guide in terms of where gross margins are going to be. I think, it's -- it continues to be a challenging environment. I think, we feel good about our ability to pass through certain costs in other areas. We don't feel as good about it and we want to hold prices.

So I think it's -- I can't tell you where exactly it's going to be. I think it's -- if I had to kind of, it will be look much like what you're looking at this quarter, maybe a little less, maybe a little more, but other than that we really just don't -- we don't guide.

Q - Edward Kelly {BIO 21274619 <GO>}

Yes. Okay, that's helpful.

A - Robert Nelson {BIO 19296866 <GO>}

Yes.

Q - Edward Kelly {BIO 21274619 <GO>}

All right. Well, the other thing that I wanted to ask about, and you kind of touched on it is just how you're navigating product cost inflation and pass through to customers, and I know historically, you would lag competition. I think maybe those like that -- the length of that lag is maybe been reduced to some extent, I don't know if that's true, just sort of color there?

And then what are you've been able to do from a vendor standpoint because you don't sell a lot of SKUs, right? So you do have some real scale advantage within those -- within those products. So I'm just kind of curious as to how those negotiations are going as well?

A - Robert Nelson {BIO 19296866 <GO>}

Well, look like we've always said, our first goal is to mitigate any price increase and our first goal is to partner with our vendor and figure out if there's a way to mitigate it for both of us. And that's the strategy, it's certainly more difficult times, because there is more pressures coming from different areas. It's not just raw material cost, it's labor, it's -- there is more factors involved in it, but look, as you alluded to, we have a -- we do a lot of volume in a relatively small number of SKUs were very important to our suppliers in terms of the volume we do in some of these and so they work with us.

And I think we-- at the end of the day, again, it's about showing the best value proposition in every item that we have on the shelf. And to the extent we're able to pass on some of those costs and we still show a great value in that item. Then that's great. In some instances, maybe we're not able to do that as effectively. But overall, I feel pretty good about our merchants being able to navigate through this. It's -- we've had a lot to navigate through the last couple of quarters and I think, I feel good about our ability to continue to do it as we look out into Q4 and then into next fiscal year.

Q - Edward Kelly {BIO 21274619 <GO>}

Okay, great. Thank you.

Operator

Your next question comes from the line of Peter Benedict with Baird.

Q - Peter Benedict {BIO 3350921 <GO>}

Hey guys, thanks. Thanks for taking the question. Bob, nice job. A question on private label, Kirkman [ph] penetration, just maybe where that sits relative to maybe a year ago. And are you seeing any particular areas where you're getting stronger traction or growth rates you are picking up there, just curious how the consumers behaving on our private label?

A - Robert Nelson {BIO 19296866 <GO>}

Yes, I -- we actually took a look at that and we were up a little bit in terms of penetration probably 30 or 40 basis points. So we're still doing a lot of business there, but again we're not, as I mentioned earlier, when I was talking about the consumer, we're not seeing, I don't think a lot of trade down or trade out into -- from brand and into our private label.

So we continue to grow it, but I think in a way that makes sense for our business and it's -- our consumers really aren't changing how they're shopping with us. I think, we're up four tenth, I think somewhere around the 26 and change number in terms of penetration on a global basis.

Q - Peter Benedict {BIO 3350921 <GO>}

Got it. Okay, that's helpful and then just -- I think, you mentioned the higher year one renewal rates, so I'm just curious maybe how long you've been seeing that? Is that a US dynamic? Is it international dynamic? Is it happening everywhere and maybe will maybe frame the numbers a little bit just to how much better, it's been. thank you.

A - Robert Nelson {BIO 19296866 <GO>}

Yes, sure. We have historically been depending on the country and area somewhere in the kind of low 50s to low, sorry high 50s to maybe 60, low 60s and those numbers now are depending on the country in the high 60s to low 70s. So we see -- we've gradually seen over the last two years since the pandemic started about a 10% bump in our first year renewal -- our first year members, if you will, which we view as very favorable as we obviously signed up a lot of new members that hadn't tried us before the pandemic. They tried us, had a good experience and we're seeing better retention rates out of those members.

Q - Peter Benedict {BIO 3350921 <GO>}

Well certainly better than it going to the opposite direction. So, good job. Thanks very much.

A - Robert Nelson {BIO 19296866 <GO>}

Thanks. Thanks, Peter.

Operator

Your next question comes from the line of Paul Lejuez with Citi.

Q - Brandon Cheatham

Hi, this is Brandon Cheatham on for Paul. I just wanted to ask about supply chain bottlenecks, any particular categories that have improved, any that have got worst. I think some of your competitors have mentioned general merch and furniture as some categories that have been challenging. I was wondering, if you all are seeing that as well?

A - Robert Nelson {BIO 19296866 <GO>}

Yes, I'm just -- I'm sitting here with Ron and he is indicating to me that we're pretty much across the board improving everywhere slightly from where we were. It's not really in any one particular category. It's -- I think part of that is there is 40 or 50 ships in LA now instead of a 100 or 120 and the fact that we've been able to utilize our own ships to kind of help get product over here.

I think, it's just improved a little bit across the board in all -- in everything that we're purchasing.

Q - Brandon Cheatham

Thanks. And I think in the past, you've mentioned that if you did have shortages, you would be able to kind of switch out a vendor or utilize an existing vendor for new product, has that kind of slowed because the supply chains improved?

A - Robert Nelson {BIO 19296866 <GO>}

Look we certainly are able to pivot more easily because we have less category business and more item business. So to the extent we're having difficulty in a particular item or have a hard time showing value in a particular item, we are able to pivot over into something else and put it in the warehouse. I don't -- I think that's just part of our DNA what we do here every day, whether it's in the environment or where -- we're operating in now or in a normal environment.

So I think, it's just a competitive advantage based on our -- the structure of our business.

Q - Brandon Cheatham

Appreciate it. Thanks and good luck.

A - Robert Nelson {BIO 19296866 <GO>}

Great, thanks.

Operator

Your next question comes from the line of Rupesh Parikh with Oppenheimer.

Q - Erica Eiler {BIO 20192312 <GO>}

Good afternoon, this is actually Erica Eiler on for Rupesh. Thanks for taking our questions. So I guess first, you touched on gas prices and driving traffics to clubs, I was just curious, given the gas price dynamics out there right now, do you think that's driving more memberships at all to clubs as perhaps consumers seek out more value in those environment?

A - Robert Nelson {BIO 19296866 <GO>}

Sure. Yes, sure. Absolute. I think every member that signs up has a different reason, but. Sure, absolutely. And particularly given the extreme value proposition in that product in that -- in gas right now.

Q - Erica Eiler {BIO 20192312 <GO>}

Okay and then just shifting gears kind of back to discretionary. You touched on seeing consumers spend in other category, which is what we're hearing from everyone out there right now, I am just curious based on what you're seeing today, has anything surprised you, in terms of the shift by category that you're seeing right now that perhaps you hadn't planned for?

A - Robert Nelson {BIO 19296866 <GO>}

Not really. I mean some of the areas I mentioned like sporting goods, well all the gyms are opening up again and a lot of -- within sporting goods, it's really exercise equipment that we sold a lot a lot of year ago and this year, the people are back at the gyms, office is down a little bit. And again, people were sitting at home offices and working from home a year ago. So it's no surprise to us that that department is a little bit softer than a year ago.

So I'm not really -- I think the categories that we're seeing, be a little bit softer than we expect or categories that we expected to be soft. It's not a big surprise.

Q - Erica Eiler {BIO 20192312 <GO>}

Okay, great. Thank you.

A - Robert Nelson {BIO 19296866 <GO>}

Sure.

Operator

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

Q - Kelly Bania {BIO 16685675 <GO>}

Well, thanks, and well done, Bob. Just another question, as you think about that 7% inflation that you mentioned, can you maybe give us a little color on how that looks on the food and consumable side versus the discretionary side of the business, and as well is there any difference in your ability or willingness to pass on some of the inflation on either side of the aisle there?

A - Robert Nelson {BIO 19296866 <GO>}

I would say in terms of our -- we're certainly seeing higher inflation in certain non-food areas although mix is bringing that down. You're going to sell fewer -- let's say, I'm making this up but patio sets that are up, say 10%. Then you say piece of apparel that might be up less so. It's going to be less of an impact on a smaller-priced item. I think overall the inflation that we're seeing is relatively the same again. We're an item business. So we're certainly seeing it higher than that in some items and lower in that in other areas of the business. And I think, again, I hate to keep using this term, but it's all about the value proposition and our willingness to take pricing along or take pricing up depends on what our position is in the marketplace.

And to the extent we continue to show great value. It's a little easier for to do that.

Q - Kelly Bania {BIO 16685675 <GO>}

Okay. And maybe just a follow-up in terms of just big ticket in general, can you just maybe talk about how that's trending? And do you think about maybe planning big ticket just a little bit more conservatively or just help us understand the internal thought process about just big ticket in the current environment?

A - Robert Nelson {BIO 19296866 <GO>}

Yeah, well again not keep using this term but we're an item business and I think, we're seeing great strength in furniture, right now. We're seeing great strength in patio, We didn't have as good inventory supplies a year ago, we have more inventory now and so we're able to move that product, things like exercise equipment isn't selling as much because or barbecues for example everybody bought a barbecue last year, because everybody was home and cooking from home.

Those -- certain items like that are not selling as well this year. I think the good thing for us is we're so broad-based in terms of the merchandise that we sell that we don't really -- I guess we don't really look at it as big ticket. Appliances is another example. Appliances are very strong this year. Now again, we had a little bit of a supply constraint last year, more issues with ships that's getting better.

It's not solved. But we're in better stock. this year, and we're certainly selling more appliances than we did a year ago. And those are the biggest of ticket items. So, well, what about it. My guys were saying travel. Not really a big ticket, but an experience and with everybody pent up for 2 years and not traveling. Yes. That business is taking off like mad. So there's a lot of discussion and talk about a recession coming, but if you look in our buildings and you look at, and if you've been on an airplane lately. You never notice it.

Q - Kelly Bania {BIO 16685675 <GO>}

Perfect, thank you.

A - Robert Nelson {BIO 19296866 <GO>}

Yeah.

Operator

Your next question comes from the line of Laura Champine with Loop Capital.

Q - Laura Champine {BIO 4748805 <GO>}

Thanks for taking my question. Can you talk specifically about what you're seeing in renewal rates in China? I know that it first -- You had such great member growth there, but I'm interested in how well you've retained those customers, just given what they've been through over the past few years?

A - Robert Nelson {BIO 19296866 <GO>}

Yeah. Laura, I don't have those in front of me actually. If you want to ping me offline we can maybe give you a little bit more color. I do know that they're slightly lower than we've seen in some markets because we signed up so many members in those first two warehouses. And so I know the retention rates are a little bit lower as a percentage, but part of that is, we opened our first building there, it was the only building and now that we have two buildings with a third coming on the Shanghai market, it's going to change the dynamics a little bit.

Q - Laura Champine {BIO 4748805 <GO>}

Got it. And then just a detail on that one-time charge, did you add a Vacation Day just basically because June 18, was made a holiday or is there something else going on there?

A - Robert Nelson {BIO 19296866 <GO>}

No, it was just for each and every employee to use as they fit, it's essentially a -- an additional floating holiday that each employee could use for a specific day that's important to them.

Q - Laura Champine {BIO 4748805 <GO>}

Got it, thanks.

A - Robert Nelson {BIO 19296866 <GO>}

Why don't we take one or two more and then David and Josh and myself will be available for some offline questions.

Operator

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

Q - Greg Melich {BIO 1507344 <GO>}

Hi, thanks. Bob, could you give us a little more insight into the ancillary businesses margin going up? Is that travel coming back, what's really driving that?

A - Robert Nelson {BIO 19296866 <GO>}

Well, certainly gas was the biggest driver in there and I think, we mentioned that travel was also one of the benefactories.

Q - Greg Melich {BIO 1507344 <GO>}

And was -- and so penny profit in gas, we should accept that that was actually up year-over-year?

A - Robert Nelson {BIO 19296866 <GO>}

Yes. It was up year over year. But keep in mind the price of gas was up 40% year-over-year. So.

Q - Greg Melich {BIO 1507344 <GO>}

Got it. The margin.

A - Robert Nelson {BIO 19296866 <GO>}

Yes.

Q - Greg Melich {BIO 1507344 <GO>}

Got it. And then a housekeeping on the day vacation, the charge, the $77 million, is that an accrual for the year or is that now in the base, and we should see that each over the next four quarters?

A - Robert Nelson {BIO 19296866 <GO>}

It's both, the $77 million was essentially to get on the books. The cost of that vacation for each employee at that time on March 14, if you will. And then the ongoing cost of that is in our regular SG&A and benefit costs, each quarter correct.

Q - Greg Melich {BIO 1507344 <GO>}

Got it. So that..

A - Robert Nelson {BIO 19296866 <GO>}

And those cost were Q3 or I should say, the 8 weeks in Q3, we're just in the regular SG&A numbers.

Q - Greg Melich {BIO 1507344 <GO>}

Got it. So now, so presumably that was 8 weeks of Q3 and we can just look at the weekly and sort of use that running forward?

A - Robert Nelson {BIO 19296866 <GO>}

Well, we didn't give you it was by week. That's what it was for the year.

Q - Greg Melich {BIO 1507344 <GO>}

That sort of was for the -- so the $77 million was for the year?

A - Robert Nelson {BIO 19296866 <GO>}

Correct. There were additional (multiple speakers) quarter relating to the 8 weeks for that benefit.

Q - Greg Melich {BIO 1507344 <GO>}

Got it, okay.

A - Robert Nelson {BIO 19296866 <GO>}

But (multiple speakers), I mean, I guess you.

Q - Greg Melich {BIO 1507344 <GO>}

All right. That's great, thanks a lot.

A - Robert Nelson {BIO 19296866 <GO>}

Yes. Thanks, Greg

Operator

Your next question comes from the line of Stephanie Wissink with Jefferies.

Q - Unidentified Participant

Hi, it's Blake on for Steph. Thanks for squeezing us in. Wanted to see if you could give any color on new member growth? You talked about gas was a benefit to attracting members and you didn't see a lot of trade down for existing members but didn't know if you could talk about maybe any new members joining the club for savings on food or non-food specifically?

A - Robert Nelson {BIO 19296866 <GO>}

Well, we don't really ask each member when they sign up, why they're signing up. I'm hoping that there is a different value proposition for each and every member that entices them to be a member and sign up. But the one thing I can add on to that is we are getting [ph] more strength in terms of the number of members that sign up digitally and that's really grown throughout the pandemic and become a bigger percentage of our growth as well.

And I think some of that has to do with some of our online offering, that hit particularly in say grocery if you don't live within 10 or 15 miles of the club, but in the pandemic you tried us, you lived a little bit further away, you had a good experience, you signed up digitally and stay digitally and you might use us half digitally and half in the warehouse.

So I think, it's a different reason for everybody really. It just depends on your preferences.

Q - Unidentified Participant

Okay and then lastly on renewal rate and that was strong in the quarter, I was wondering how that was versus your expectations and also the MFI growth versus your expectations as well? Thank you.

A - Robert Nelson {BIO 19296866 <GO>}

Okay. My guys are telling me, I didn't know, but I think, it was pretty much in line with what our expectations were. I mean, we continue -- when you kind of take a look at what's driving that, we continue to convert more base members to the executive member program, who tend to renew at a higher rate and have more loyalty with us that's contributing to that. We see that every week. So we know that's going to help the renewal rates and so I think, based on watch [ph] and then of course the first year renewal rates that are improving, we know that's going to help the number as well and signing up more members. So all that I think is contributing to those improved metrics, if you will.

Q - Unidentified Participant

Thanks, Bob. That's helpful.

A - Robert Nelson {BIO 19296866 <GO>}

Okay. If there's no more questions, we'll call it a wrap. I appreciate everybody dialing in today. And again, David and Josh and myself are available if you guys have any follow-ups. Have a good day.

Operator

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