Q3 2023 Earnings Call

Company Participants

- Richard A. Galanti, Chief Financial Officer

Other Participants

- Brandon Cheatham, Analyst
- Christopher Horvers, Analyst
- John Heinbockel, Analyst
- Karen Short, Analyst
- Michael Lasser, Analyst
- Oliver Chen, Analyst
- Rupesh Parikh, Analyst
- Scot Ciccarelli, Analyst
- Scott Mushkin, Analyst
- Simeon Gutman, Analyst

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Costco Wholesale Corporation's Fiscal Q3, 2023 Conference Call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question-and-answer session. (Operator Instructions) Thank you.

Richard Galanti, CFO, you may begin your conference.

Richard A. Galanti {BIO 1423613 <GO>}

Thank you, Josh, 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 third quarter of fiscal 2023, the 12 weeks ended this past May 7. Reported net income for the quarter was $1.30 billion or $2.93 cents per diluted share compared to $1.35 billion or $3.04 per diluted share a year ago in third quarter. This year's results included a non-recurring charge to merchandise costs of $298 million pretax or $0.50 per share, primarily for the discontinuation of our charter shipping activities. Last year's results included a nonrecurring $77 million pretax charge or $0.13 per share for incremental employee benefits. As many of you know, two years ago, we initially leased three ships and thousands of containers to help mitigate some of the significant overseas freight challenges that we were experiencing. Later, we added four additional vessels and several 1,000 additional containers with commitments made for upto then three additional years.

Procuring these ships and containers was integral to us being able to stay in stock for our members during those challenging times. It also allowed us to do so initially at a lower cost in the market rates at that time. Shipping and freight markets have improved dramatically since that time, which led us to reevaluate our position. As you recall, in fiscal second -- first quarter of this fiscal year, we took a charge to downsize by two vessels of our chartered shipping activities. Since then shipping and container rates have continued to fall and then in the third quarter -- this third quarter, we concluded that would be appropriate to completely discontinue the remainder of our charter shipping activities. As a result of this decision, we recorded an impairment charge for all remaining charter assets. This decision allows our merchandising teams to take full advantage of the current shipping market rates as opposed to much higher contracted charter rates, in turn, this allows us to do what we do best and lower prices for our members.

In terms of sales, net sales for the third quarter increased 1.9% to $52.6 billion versus $51.61 billion reported last year in the third quarter. Comparable sales for the quarter were as follows; in the U.S. on a reported basis, minus 0.1%, and excluding gas deflation and FX, plus 1.8%; Canada reported minus 1.0%, reported ex-gas and FX, plus 7.4%; and other International reported plus 4.1% and ex-gas and FX, plus 8.4%, so total company on a reported basis, 0.3% comp sales and ex-gas deflation and FX, plus 3.5%. And our e-commerce on a reported basis was minus 10.0% and minus 9.0% excluding FX. In terms of third quarter comp sales metrics, traffic or shopping frequency remains pretty good, increasing 4.8% worldwide and 3.5% in the U.S. during the quarter. Our average daily transaction or ticket was down 4.2% worldwide and down 3.5% in the U.S., impacted in large part from weakness in bigger ticket non-foods discretionary items. Foreign currencies relative to the U.S. dollar negatively impacted sales by approximately 1.5% and gas price -- gasoline price deflation negatively impacted sales by approximately 1.17%.

Next on the income statement is membership fee income. For the quarter, we reported $1,044 million of membership fee income or 1.98% of sales compared to $984 million or 1.91% a year ago in the third quarter. So, a $60 million or 6.1% increase in membership fees. Excluding the headwinds in FX, the $60 million increase would have been higher by $17 million or up year-over-year 8% adjusted for FX. In terms of renewal rates at third quarter end, our US and Canada renewal rate was 92.6% and our worldwide rate came in at 90.5%. These figures are the same all-time high renewal rates that were achieved in the second quarter, just 12 weeks earlier. Membership growth continues. We ended Q3 with 69.1 paid household members and 124.7 million cardholders, both up approximately 7% versus a year ago. At third quarter end, we had 31.3 million paid executive members, an increase of 681,000 or 57,000 per week during the 12-week fiscal third quarter. Executive members now represent a little over 45% of our paid members and approximately 73% of worldwide sales. Moving down the income statement, next is our gross margin. Our reported gross margin in the third quarter was high year-over-year on a reported basis by 13 basis points, coming in at 10.32% as compared to 10.19% number a year earlier. The 13 basis point positive ex-gas deflation was plus -- was minus 3 basis points, both of these numbers, of course, includes little more than 50 basis-point impairment charge to margin mentioned in today's earnings release.

As I normally do, I'll ask you to jot down a few numbers, two columns, reported column and then the columns excluding gas deflation. The first item would be for the third quarter of '23 core merchandise margin, on a reported basis it was up year-over-year to 39 basis points and ex-gas deflation up 24. Ancillary and other plus 13 and plus 9. 2% reward, minus 11 and minus 9. LIFO plus 25 and plus 25 and other minus 53 and minus 52. If you add up the two columns, again you get to the reported number of on a reported basis gross margin year-over-year in the quarter was up 13 basis points and ex-gas deflation down 3 basis points. So starting with the core, again core was up on a reported basis 39 basis points year-over-year and 24 ex-gas deflation. In terms of core margins on their own core sales or core-on-core margins, they were higher by 17 basis points with food and sundries and non-foods being up and fresh foods being down a little. Ancillary and other businesses, gross margin was higher by 13%, and again higher by 9% ex-gas deflation. Within the ancillary businesses, gas, the lean business centers, food court and travel were better year-over-year, offset in part by e-com. 2% reward again higher by 11 basis points and higher by 9 ex-gas deflation. Higher sales penetration coming from our executive members is certainly part of that.

LIFO plus 25 basis points year-over-year, both with and without gas deflation. As you recall, a year ago in the third quarter, we had a $130 million charge for LIFO. In this fiscal year, we had no LIFO charge, so a $130 billion year-over-year improvement on that line item. Note also that in the fourth quarter a year ago, we had a $223 million LIFO charge. So we'll see how that goes in the fourth quarter of this year. Other was lower by 53 basis points reported and 52 basis points ex-gas deflation. This was net of items from both years. This year there was a 57 basis point negative impact from the $298 million pretax charge, again primarily related to terminating our charter shipping activities. This was partially offset by lapping last year's $77 million charge for incremental employee benefits, of which $20 million or 4 basis points related to gross margin. The remaining $57 million, I'll talk about it in a minute under SG&A. Moving onto SG&A, our reported SG&A this year was 9.11% compared to 8.62% a year ago. So on a reported basis, higher by 49 basis points and ex-gas deflation, higher by 34 basis points. As with gross margin, I'll ask you to jot down two columns of numbers, both reported and one with excluding gas deflation. The first item is operations, minus 48 basis points or higher by 48 basis points and minus 35 basis points. Central, minus 11 and minus 9. Stock compensation zero in both columns. Preopening minus 1 and minus 1. Other, plus 11 and plus 11. If you add all those up, again on a reported basis 49 basis points higher year-over-year and ex-gas deflation 34.

The core operations, this negative include, of course, the impact of slower sales growth as well as the impact of a few of the wage increases that we did typically out of the normal cycle over the last year-over-year, and that included the impact of four weeks of wage and benefits increases implemented last March. The additional top of scale increase that went into effect July 4 and eight weeks of this March is higher than normal top of scale increase. Despite the slowing sales growth, we've continued to invest in our employees over the past year and that's always been a priority for us. Central, higher by 11 and a higher by 9 ex-gas deflation. Again sales growth, no big single item was an outlier there, but sales growth overall might be was the impact. Stock-comp is flat both with and without gas deflations, no impact there. Preopening again higher by 1 basis point. We had five openings this year in the quarter and three in last year, but again 1 basis point delta year-over-year. And other, the 11 basis point positive, both with and without gas deflation, this result of lapping that $77 million charge, but within SG&A, lapping $57 million of that $77 million charge for the incremental employee benefits, and again discussed earlier in the release. Below the operating income line, interest expense came in at $36 million, $1 million over last year's $35 million number. And interest income and other for the quarter was higher by $57 million year-over-year. This was driven by an increase in interest income due to higher interest rates and cash balances and interest -- increase in interest income was partially offset by less favorable FX versus last year.

In terms of income taxes, our tax rate in the third quarter came in at 26.5% that compared to 24.9% in Q3 last year. The fiscal '23 effective rate excluding discrete items is currently projected to be in the 26% to 27% range. Overall, reported net income was down year-over-year by four percentage points. Net of the two nonrecurring items in both years' third quarters, net income would have been up 8% even with being reflective of that higher income tax rate. In terms of warehouse expansion, to date, we've opened 17 locations in the first three quarters, and also including three relocations, so net of that 14 net new locations. In Q4, we have nine new openings with no relos, so net of nine, that will put us at 26 openings, less the three relos to be at 23 net new for this year. In the quarter, again we opened five with one -- with four being net new. In addition to the relocation in Canada, we had two new buildings in the US open and one additional building opened in Japan -- in each of Japan and China. We have, again nine new buildings planned for our fiscal fourth quarter, that includes our North Tulsa, Oklahoma opening that opened this morning and our fourth and fifth buildings in China, planned for June and August. These Q4 planned openings will bring our full year accounts to 26, less the three you are at 23. And it's made up of 13 in the U.S. and 10 outside of the U.S. Regarding capital expenditures in Q3 of the quarter -- of the fiscal year, we spent approximately $819 million. Our estimate for all of fiscal '23 CapEx is approximately $4 billion.

Moving onto e-commerce, you saw in the release that e-commerce was at minus 10% sales decline and on a comp basis, and ex-FX minus 9%. E-com sales more to the same story in terms of the sales as I discussed on our second-quarter call and in our monthly sales recording. In Q3 big-ticket discretionary departments notably majors, home furnishings, small electrics, jewelry, and hardware, were down about 20% in e-comm and made up 55% of e-com sales. The same departments were down about 17% in warehouse but they only make up 8% of warehouse in warehouse sales. A few comments on inflation, inflation continues to abate somewhat. You go back a year ago to the fourth quarter of '22 last summer, we had estimated the time that year-over-year inflation at the time was up 8% by Q1, and in Q2 it was down to 6% and 7% and then 5% and 6% and this quarter we're estimating that year-over-year inflation in the 3% to 4% range. We continue to see improvements in many items, notably food items like nuts, eggs, and meat, as well as items that include as part of their components -- commodities like steel and resins on the non-food side.

Switching over to inventory levels. Inventories overall are in pretty good shape. As of quarter end, our inventories year-over-year as of the end of the third quarter were down 7%. Recall that they had been up during some of the supply-chain challenges of last year. Finally, in terms of upcoming releases, we will announce our May sales results for the four weeks ending Sunday -- this Sunday, May 28, next Thursday, on June 1 after-market close, and also remember that our fiscal fourth quarter has an extra week this year, so our quarter-ending September 3 of 2023 will have 17 weeks versus 16 weeks in the fiscal fourth quarter.

With that, I'll open it up for questions and answers and turn it back over to Josh. Thank you.

Questions And Answers

Operator

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

Q - Michael Lasser {BIO 7266130 <GO>}

Good morning or good afternoon, Richard. How broadly and widely is Costco willing to roll back prices in order to drive traffic and sustain mid-single-digit comp growth? How are you thinking about the prospect of deflation across your entire portfolio? Thank you.

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

Well, look, that's something that our merchants work on literally every day and every week. I remember when inflation was peaking at 89% and some out there would say we're known for trying to hold the line, work with our suppliers, how much will they eat [ph] of that, how much will we eat of that, and at the end of the day, if margins year-over-year were down 50 basis points or 100 basis points back then that implies that some portion of it, maybe instead of an 8% to 9% increase, our members were seeing a 6% or 7% or 8% increase. Whenever that was, we felt that we were doing as good a job as anyone out there in term -- given the item nature of our business to lower prices for our members and hopefully drive sales. Certainly, right now we're -- we've always been a little bit compared to others over-index in bigger ticket discretionary items that's getting hit arguably more than others. If you look at our fresh foods and food and sundries, they are in the mid-to-mid high singles. You look at the non-foods and some of the ancillaries, notably, gasoline, which is 11% year-over-year deflation in gas prices, that's in the mid-single negative. So it all adds up to where it is.

Every day, we look to drive sales. What will it take to get whatever excess, who the heck knows? I just know that our merchants and Greg and Ron and Claudine, our Head of Merchandising, are pushing the buyers each day to do that and figure out how can we take the monies that we get, any type of monies from the vendors, they can usually use to drive business. One of the reasons that it made sense for us to discontinue the containers and shipping vessels is to reduce the cost that our buyers are seeing relative to these higher -- much higher contract rates now. We were smart for a year and now looking back, it was good to get out of it and that allows us to be more competitive as well. So, I think we're doing a great job of being very competitive. When we do comp shops against our direct warehouse club competitors, as well as different components, whether it's retail food or general merchandise on the buildings -- home improvement side, we feel very good about our competitive position and what we're doing to do that.

Q - Michael Lasser {BIO 7266130 <GO>}

So are you not expecting broad-base deflation, Richard? And my follow-up question is going to be, given the amount of value you give to your members, wouldn't it make sense to raise your fees right now, so they -- because renewal rates have been so high and you would be providing any more value in this difficult economic churn.

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

Well, first of all, on the question of deflation, let's hope that there is, and you'll be the first to see it at Costco in my view. As it relates to membership fees, nice try, Michael, but at the end of the day with the headline being inflation, we feel very good about if we want to do it, we do it without impacting in any meaningful way renewal rates or sign-ups or anything. And at some point, we will, but our view right now is that we've got enough levers out there to drive the business and we feel that it's incumbent upon us to be that beacon of light to our members in terms of holding them for right now. It's not a matter of a big time, but we'll let you know as soon as we know.

Q - Michael Lasser {BIO 7266130 <GO>}

Thank you.

Operator

Your next question comes from the line of Simeon Gutman with Morgan Stanley. Your line is open.

Q - Simeon Gutman {BIO 7528320 <GO>}

Hey, Richard. My first question is on the comps and the stacks. It's obviously been slowing and you probably took more than your fair share over the last three years, curious when you sit around, how you're diagnosing it, macro, I don't know if it's gas attachment, merchandising, whether any of those options, how do you diagnose what's happening?

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

Yeah, well, first of all, we look at traffic and we're getting people in the door and we know what they're buying. They're buying non-discretionary items, they're buying fresh foods, they're buying food and sundries, they're buying apparel in a big way, they're buying patio furniture, now that the weather has turned in a big way, indoor furniture not as much. We all know what's going on with consumer electronics out there, while all the members industry-wide are down, ours are down a little less, but they're down. So overall, when we look at what else can we do to drive more non-food business, but at the same time, can we bring in a few more items on the food and sundries side because we know traffic is good there, simple impulse items that sulfur $15 to $25. So that's what we do every day and that's what Claudine and her staff and merchants are doing.

Q - Simeon Gutman {BIO 7528320 <GO>}

And then, my follow-up, can you give us some information or color on gasoline gross profit year-over-year, how that profit pool is trending, obviously, inclusive of both gallons and the penny profit?

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

Well, yeah, gallons are close to flat. The average price per gallon during the quarter was down 11%, so that's 12% -- I don't have the number, 12%, 13% of our sales, which was the average price point for cell units if you will was down 11%. Year-over-year gasoline was profitable in both quarters nicely. As I've said, I think I'm sure I said last year in Q3 and this year it helped -- it didn't help a little -- it helped a little year-over-year, but not a lot. Last year in Q4, it was a strong number, and with that extra week, we'll see how it goes this year, but right now gasoline continues to be quite profitable for us.

Q - Simeon Gutman {BIO 7528320 <GO>}

Okay. Thanks, Richard.

Operator

Your next question comes from the line of Christopher Horvers with J.P. Morgan. Your line is open.

Q - Christopher Horvers {BIO 7499419 <GO>}

Thanks very much, and good morning. So I just wanted to jump back to the pricing question, from a strategy perspective, typically if you see things that are disinflating [ph] or deflating on more of the commodity side, you take price ahead of that. I guess, is that what you're doing currently? We've heard a lot of talk in the market about the vendors funding more promotions, how are you thinking about the balance between the retailer funding the promotion, the price investment versus the vendors?

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

Well, first, look, we work with our suppliers every day and it's going to be a partnership there. Again, I think it's easier for us in the one hand that we do a lot of volume on fewer items. We're managing -- we have buyers that literally we're managing a couple of dozen items not 200 items. And I remember when certain commodity prices like resins and steel were going up in our monthly budget meeting here from the merchants sell, what we're committing out five months, six months for seasonal items like patio furniture, barbecue grills, couple of years ago. We want to know when the vendor was increasing the price whenever, whether it was a major consumer products company or manufacturer of non-food items like that, why -- exactly why, how much of it is labor, how much of it is commodity costs and how much is the transportation costs. and then as prices -- and wage pressure, whatever. And as we saw commodities coming down, I think -- I'd like to think that we were the first on the phone with our suppliers, getting -- wanting to know when the price is going to drop. And understandably, in some cases, the supplier had committed to a season of three or four months, and so there was some delay and we worked with them in there. In addition, as we said, we're going to invest a little on price, how much are you willing to invest in price, so it's a partnership.

And I think we are better positioned to do that simply because if you take our $230 billion or $240 billion in sales and divide it by 3,800 skews, it's a lot more pricing power per skew and a lot more focused on an item-by-item basis. So that's what we do. And as their promotional money is out there from the suppliers, this goes back to the beginning of time around here. I remember with the traditional co-op advertising dollars, as supplier one you just spent $0.05 of our own money and add it to $0.05 there's to do $0.10 of advertising of their product. And we say, just give us the $0.05 and we will base the (inaudible) cost not dollar cost, and that's what we still do. And so I think, we have to be smart about knowing what every bucket of money is out there, whether it's promotional monies or ad monies are or ad money is online now, and work with our suppliers to do that. And in our case also we do what we call the MVM, the multi-vendor mailers, the coupon bookers we send out 11 times a year. And not only that but hard buys in-store and what we call temporary price discounts and what could drive sales. The other part of that is when we get monies in some cases, what -- how much elasticity is there and driving business by lowering the price. In some categories, particularly some of the bigger ticket categories right now there's not an appetite by the consumer necessary for that, so how do we add value to the item or do more things to drive business, it's all the above.

Q - Christopher Horvers {BIO 7499419 <GO>}

And so, as you look forward, I know you said, I think 3% or 4% inflation in the quarter. Look at the Nielsen data that was sort of low-double-digit, right, I mean Walmart talked about that. So, two-part question, one is, is the difference just mix that you have more fresh commodity exposure? And then, if you project forward that you'll have sort of no inflation potentially six months, eight months out, so how do you think about your ability to continue to comp overall?

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

Well, you know, when there was low inflation and not an over-arching concern about a recession when the world seemed to be comping three, four, five, and six years ago at 2% to 4%, we were 5% to 7%. Our view is because we got great members buying more with great loyalty and great -- the best prices, a major difference, and quality. And so, we've succeeded under those. I think, right now, more of it -- in my view, more of it relates to the fact that we're not only dealing with big-ticket discretionary items weakness which again when we look at like MBV [ph] and everything, we're doing better in most of those categories. Our negative is not as negative as others out there. In addition, we're comparing against two years of outsized growth and some of those things as people are buying things from their home. We saw outsized sales in indoor and outdoor furniture and electronics and TVs and exercise equipment and so we're not only comparing against this "recession" our concern is about big ticket items but comparing against Uber strength over the last two years prior to that.

So I think we'll come out of this fine. We're pretty good at figuring out new items and new things to do and we're not just focused on how do we drive sales other 1% or 2%, but how do we drive sales by bringing in new and exciting stuff and we continue do that. This is anecdotal, but over the last year, year and a half, we've always been very good at taking what I'll call big American Costco products including a lot of chaos and having huge success overseas. We're now on a conscious basis figure out what unique exciting overseas items can we bring elsewhere in the world including the US and Canada and we're having good experience with some of those things. These are all small things, but there's lots of little small things around here that add up.

Q - Christopher Horvers {BIO 7499419 <GO>}

Got it. Thank you so much.

Operator

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

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Good afternoon, guys. Scot Ciccarelli. Richard, I think you mentioned fresh foods were a bit on the softer side when you kind of look at the data, is that a function of your members moving to less expensive package goods or is that more just due to the COVID-driven comparisons like you were just talking about on the discretionary side?

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

Yeah, by the way, when I was talking earlier about down the margins were a little weaker in fresh. sales have been fine in the quarter. Again, when you look at reported total company sales number of 0.3% or 3.5% ex-gas and FX, but within that 0.3% reported, fresh was mid-singles, food and sundries is mid-to-high singles, non-Foods was a little over mid-single negative.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Got it. (inaudible) So the second question related to that though are you seeing any other kinds of trade, let's call it trade down type activity, whether it's more private label sales, et cetera, that you can identify from your members? Thanks.

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

Yeah, no, by the way, not just in this current "recession or concern for recession." Historically, we've always seen someone -- like within fresh protein, we've always seen when there's a recession, whether it was '99 -- '08, '09, '10, we would see some sales penetration shift from beef to poultry to import. We have seen some of that now. I think anecdotally I heard a few months ago from our Head of Food and Sundries buyer that we saw some switch even to some canned products, canned chicken and canned (inaudible) things like that. But on the can side, we've also seen that, I think last quarter, I mentioned that on a year-over-year basis, whether it's a 150 basis point increase in private-label, sales penetration, and this year, at the end-of-the quarter was 120 basis points, so still over a full percentage point delta in sales penetration. If you go back over the last 10 years, my guess is that on a year-over-year basis, maybe we've gone from, I'm guessing, 22% or 23%, the 25% or 26%, so call it 300 basis points over 10 years or eight years, so you 30 to 50 basis-points versus 120 basis points and 150 basis points in the last couple of quarters. So, yeah, that would again and at least anecdotally suggest that we've seen people looking for better bargains. We try to correct people when they said it was a downgrading and argue it is an upgrade when they went to Kirkham [ph]signature.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Got it. Thank you very much.

Operator

Your next question comes from the line of Karen Short with Credit Suisse. Your line is open.

Q - Karen Short {BIO 7215781 <GO>}

Hey, thanks very much. Good start 2Q. Two questions. One is, your pretax margin is one of the highest I think I've seen in the model, like I'm not even sure I could go back to when it was as high as it was. So I'm curious if you could just make some color or commentary on that. And then the second question I had was, not that we're necessarily going into deflationary [ph] environment in food, but if we were to go into deflationary environment in food, what would be the deleverage you would see on the EBIT line on that front?

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

Well, we will revise, even configure a number off top of my head here. In our view, first of all, deflation will be the first out there lowering prices with it and I'd like to think that we can drive business with it. The other thing is, look at even something like gasoline. I think all retailers out there that have gasoline operations have in the last few years reflected higher profitability from gas. In our view, we have higher profitability and we still -- we have the most extreme savings versus everybody else. So we've been able to make a little more per gallon because others have decided to make more than a little more. I think the same thing holds true elsewhere. When we look at our competitive price shops against our direct club competitors and against others on key items like fresh with supermarkets, again those price gaps between us and our competition have not changed, There is still as strong as we feel that they shouldn't be. And so again, it's hard to say what -- your comment about some of the highest pretax margins, let's say, I remember looking at even like SG&A, which was up year-over-year of course.

If you go back, pre-COVID I think our SG&A on a reported basis was had a 10 in front of it. It was like 10.1% or 10.0% and our view is could even get below 10% and with COVID increasing sales for two years, we benefit, of course, more than we were detrimental by COVID in many of our categories and we got down below 9%. And of course, normalize it's still better than it was and margins are still better than they were. So, I think some of it is sustainable. Wage pressure -- wages are not going to go down. The question is will they continue to go up? Again, we're going to be ahead of that too in terms of wanting to make sure we take care of our employees. But let's assume that a big chunk of that is if overall inflation subsides a little bit, I think we'll see a little less wage pressure. But look, as you know, Karen, with us, it's top-line sales mostly and the biggest thing can affect anything, I think we've shown that even with some lesser top-line sales, we've been able to pull the levers in a way that still allows us to drive bottom-line and will continue to be pragmatic about it, but we'll have to wait and see.

Q - Karen Short {BIO 7215781 <GO>}

Sorry, just to follow-up on that. So, is there any way to frame what ex--gas margins, ex-fuel prices like what delta in sales would result in a delta in EBIT, is there any way to (multiple speakers).

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

It's hard to say -- not really, I mean, we used to look at almost like the old way equals that extra speed model, based on incremental sales what's the variable rate of expenses in a warehouse. In our collective view, this goes back several years, but our collective you was as you need it, somewhere around 4.5%, whether it was four or five, but a comp number to have flat SG&A or flat expenses at the warehouse. Certainly, taking the weakness right now in big-ticket items, that's -- or -- and then taking the weakness of gas deflation, those things impact that SG&A percentage more than anything. When I look every month at our budget meetings when the operators report on labor productivity, sample and fresh, we're still improving in the 3% to 6% labor productivity and pounds of protein, processing pork, poultry, and beef that meet through the system. When we look at front-end labor, warehouse labor, not the ancillary businesses or the fresh foods or anything, but labor hours, we've shown, labor productivity. Now, in the last year with slower -- little slow in our sales and with three unusual additional wage increases, that's going to still show a labor percent number higher as a percent of sales, which is our single biggest SG&A item bigger than other things. But look, at the end of the day, we're still a top-line company in our view that will mend all things, we'd like to see -- I'm sure we'd like to see something pre-inflation back in the five to seven or eight range. But let's get from where we are now, the 3%, 4%, and we'll go from there.

Q - Karen Short {BIO 7215781 <GO>}

Okay, understood.

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

Now, the agenda is also is, if I look back the last -- well, this is the second quarter that we've seen that discussion of lower sales of big-ticket discretionary items, it started actually I think a little bit in the quarter prior to that, not the entire quarter just a little bit in there. So, if you will there's -- if all things being equal, would be comparing against easier compares, six months from now, but hopefully, we can do a lot of our own as well.

Q - Karen Short {BIO 7215781 <GO>}

No, that makes sense. Thanks so much.

Operator

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

Q - John Heinbockel {BIO 1508150 <GO>}

So, Richard, core-on-core food and sundries and non-food were up, right? So, it's kind of a two-part on core-on-core. One, what drove that, was that predominantly mix? And then secondly, fresh food was down, where is fresh food versus '19 and are we kind of getting to the point where those -- that erosion is, it's going to stop, we're pretty close to '19.

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

Yeah, look, fresh foods is still up year-over-year on margins versus '19, right, fresh foods margins are up versus '19, way up, I mean I think, hold on a minute -- yeah, if I look back at just fresh foods, if I go back to '21, we had a couple of quarters where fresh foods margins were up 200 basis points and 300 basis points year-over-year in the quarter. By the end of '21, this is near the end of -- this is lapping that craziness -- that's crazy goodness, we were down 190 basis points. And for all of '22, we were down anywhere from 50 basis points to 120 basis points on a year-over-year basis. Some of that compared to those plus 200 basis points and 300 basis-point numbers. This year we're down again versus last year and down -- but down versus that giant increase in fiscal '21. When I look at where our food gross margin is today in Q3 versus pre-COVID, we're still up.

Q - John Heinbockel {BIO 1508150 <GO>}

Okay. But the other categories that were up, right, is that predominantly mix, private brand, and less big-ticket?

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

I think it's mix -- like some of the nonfood strength, as I mentioned throughout, apparel is one of them. Apparel has a strong margin -- and apparel has a strong margin relative to all of our departments anyway and majors has a weak margin generally anyway, and then of course, lowered penetration of that.

Q - John Heinbockel {BIO 1508150 <GO>}

All right.

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

And freight is -- by the way freight is up too, particularly on big-ticket items, furniture, the late good goods, exercise equipment, and things like that.

Q - John Heinbockel {BIO 1508150 <GO>}

And then secondly, where are we on the personal personalization journey, right? Because, I know you've done more data analytics in the last couple of years, but (technical difficulty) the loyalty program, right? So, when you think about wallet share and targeting promotions and emails and so forth, it looks like a huge opportunity, where are we on that?

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

Sure, by the way, one other question that we've gotten couple of times of late because of some of the companies out there reported much higher shrink, our shrink is intact. We haven't seen any major change in shrinkage. It fluctuated a couple of three basis points up really before COVID as we've rolled-out self-checkout and since then it's come back down a little bit. And so it's been a very tight range and so we've been fortunate in that regard. And in terms of where we are in personalization, for those of you on the call that have known me forever, it was probably four years ago that we talked about that sometime soon we'll do targeting and after that do personalization. Well, we're still in the early innings, but I guess what I'd like to tell you and I think I mentioned this on the on the last quarter's call. Just under a year ago, we hired a new VP of Digital -- Digital Transformation, if you will, both in e-com and mobile sites and applications, that complemented three other outside VPs we hired, one of which was in the data analytics area and we've really over the last six months to nine months, began a two-year roadmap to improve or re-platform our primary e-commerce website and the same goes for our mobile apps and mobile site.

Working, of course, with data, analytics people, the architect people, as well as business users, we're currently building and dramatically increasing the number of engineering capabilities that we have and we're on our way, but I'd say we're in the early innings. First order business to have, which we now we feel we've got into much better, clean data site. We are still sending you too many emails a week that don't pertain specifically to what you do, but I think you're going to see incremental changes and I'll be able hopefully report more on that at the next quarterly call. And just in the last three months as an example, we've had three small releases to our mobile app that are improvements of it. And we're now on plans to have small improvements in that app, each month for several months going forward. And so you really, as you know, you've heard me say for the past couple of years that we're in the early innings, I'll repeat that. We are but we actually got it. I think a good game plan and you'll see more to that over the future. A little longer than we had hoped to do some of this stuff, but I think we're on our way in that regard.

Q - John Heinbockel {BIO 1508150 <GO>}

Okay, thank you.

Operator

Your next question comes from the line of Oliver Chen with TD Cowen. Your line is open.

Q - Oliver Chen {BIO 15320650 <GO>}

Hi, Richard. When you think about household income, what kind of trends you're seeing in terms of your customers and people trading and you Costco at large? And then the big-ticket item question, what's your -- what are your thoughts on how you're planning inventories there, the comparison is, do you expect improvement within big-ticket, any color in terms of how that may perceive sequentially? Thank you.

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

Sure. Our annual household income has actually gone up a little bit, but I think that's more to do with wage increases than anything. We still over-indexed to higher-end people -- higher-end income people, and so that's still there. As it relates to our inventories, again, if you'd asked me six months ago, in fact, it was I think it was Q3 and Q1, Q4 and Q1 where year-over-year inventories were up 26%, as was our competitors and everybody else, a lot of that had to do with, one, some people had enough big-ticket items, but also just terrible supply-chain challenges that we all had. And since then, like others, we've shown a reduction in that dramatically and that's good. We feel pretty good about where we stand right now. If you -- some of you have noted and called us on back again six, five, four, three months five months three months ago, we had a lot of promotional things going on. If you bought three or more thousand dollars of these 10 items, and they're all different patio items or different in-store furniture items, it's three thousand or more, you got a $500 Cashcard on already great pricing and that was a lot of our promotional money -- market money to get our inventories back-in line, particularly on things where we were over-inventory because the supply-chain delays.

And then on some examples, I think air-conditioners might be an example because of the supply chains last summer we did great in selling through fans and air-conditioners, but these are not exact numbers, but let's say we plan to sell $500 million of it, easily 20%, 25% of it got here after the summer because of the supply chain challenges. There is no need to mark those down to try to get rid of them in September-October, we held them and we're selling through them now and that's not an issue at all. So, in talking to Claudine Adamo, our Head of Merchandising, and her non-food people, we feel pretty good about where we are both on existing inventory levels of what we have in there and as well as what we've committed to going forward for upcoming seasons, notably back-to-back to school and Christmas and things like that.

Q - Oliver Chen {BIO 15320650 <GO>}

Okay. And Richard, you've made a lot of great strides in Asia and China and other regions, I'd love to have some highlights in terms of what's ahead for the back half there. And the second question connected consumer experience between digital and physical are there evolved box in terms of focus and curbside and what your members want and delivering the ultimate convenience? Thanks.

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

Sure, well, first of all, in terms of expenses outside the United States, if you look at just even this year, at '23, I think it was 13% and 10%, so 60%, 65% in the -- 60% in the U.S., Canada, which I combine as one because it's well saturated, but we're still opening a bunch of units there and it's our oldest areas. I see that over the next five years, going from 65-35 or 60-40, to at least 50-50 if not trending a little bit towards outside the US and Canada. Now that again is the same answer I would have given you six, seven years ago for now and I think that's a function of one having more opportunities every day that we thought we had before in the U.S. and Canada, and there are plenty of opportunities going forward elsewhere.

You're going to -- I think you're still going to see us open in Korea, Taiwan a unit this year on a base of somewhere in the mid-to-high teens. In Japan, more than a unit a year, on a base in the low 30s. A unit a year in Australia, not exactly each year maybe one year none and then two, but in Australia, we got 14 I believe, and in Europe we're dominantly most of our units are in the UK where we've gotten the low 30s, we're still going to open one or two a year there or one a year, probably and we've opened a few others. We opened our fourth in Spain and we now have two in France and one each in Iceland and Sweden, so a little growth there. Certainly, in China, I mean China is a big story this year for us as one of the stories is that we opened our first unit in China 3.5 to 4 years ago, our second a year and a half ago, our third last December, and three more this year. We will be at six at the end of this year, this calendar year, I'm sorry, this calendar year. Two more this fiscal year and then one more in the fall. So there's certainly more growth there. But that's not a lot of growth relative to some companies that have tried to go and open 20 somewhere or something. But we feel good about how we do that, but we think there's plenty on -- if you look at the bottom line, if we're opening 23 to 25 a year, we'd like to be a little 25 plus a year for the next five years and somewhere closer to 30 a year in years six through 10 years, that would make us feel quite good. And we feel very comfortable that we can do that at this juncture.

In terms of curbside, we're not very thrilled about it or maybe a little stubborn about it. We tried it in a few locations a year ago and successfully proved to ourselves we don't like it, and we want you to come in and now we do have lockers from big-ticket non-food items. Interestingly, when people do that, they come in and over half of them shop while they're in the location. So, one of our challenges which is a good-quality problem to have is our average volume per warehouse has continued to grow way more than we had thought a few years ago and we have -- last year we had over 150 locations doing over $300 million, I think over 27 or 28 doing over $400 million, and 26, and so we've had to open more units, and so we continue to look at a lot of places, even in the U.S. And we don't get a lot of for it honestly. Now, we're not asking a lot about it either, but we don't get a lot of ask for it, so I don't see that being as a big thing. One of the things that we will be doing though is even online, when you go to look at online product, if we're selling it in the warehouse near you based on where you shopped, in the next several months, cross my fingers, you will be able to say, you can go ahead and get it in-store at the Kirkland at the (inaudible) location, which also has an in-stock right now.

And in some cases, yeah, same-day grocery, of course, we already have with delivery, mostly within -- we partnered with a couple of other people as well, but they're the big member there, both in the U.S. and Canada, and we do two-day dry -- Yeah, by the way, that number which continues to (inaudible) is not reporting in our income numbers. In that case, their employer or contract employee comes in shops, brings it up, and place a deal, so that we consider a warehouse sale.

Q - Oliver Chen {BIO 15320650 <GO>}

Got it. Very helpful. Thanks, Richard.

Operator

Your next question comes from the line of Scott Mushkin with R5 Capital. Your line is open.

Q - Scott Mushkin {BIO 7138867 <GO>}

Hey, thanks, Richard, for taking the question. So I wanted to talk about competition a little bit. But first, shorter-term, and then, maybe I missed the answer to this I think when it was asked, promotional activities now, are they -- someone when you compare, they really kind of ramped up, is that what you're seeing as well?

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

Yes, it's higher than it was. Now, mind you, it was a lot lower for a couple of years because of the supply-chain challenges. I mean every TV we can sell, every -- whatever we could -- not (inaudible) we could sell every paper goods we could sell. We actually took some items out of like the MBN [ph] mailers on the sundries side because when there were shortages like paper goods and why promoted when first of all, we got to limit one per customer? And so, so some of those comparisons is, there's more versus a lot less for a couple of years as well, but yes, we are seeing more now.

Q - Scott Mushkin {BIO 7138867 <GO>}

And is that purely from the vendors or is that from activities you're seeing from retailers themselves?

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

Well, you mean -- well, I can speak for us. Yeah, I mean, certainly, when we see something that other retailers are doing, we want to make sure we ask our supplier, maybe they can tell us, but we're putting the pressure on to know that we are seeing some unusual things out there and while we hold sometimes we see better deals the following day to us. So we just got to stay on top of that. But in terms of, I think -- as I said a little earlier, I think we've got a lot of levers to pull, certainly, all retailers that have gas right now have continued to help with that. Unusual things like fresh has been relatively strong and so we feel good about that. Things like even apparel, which is close to a billion-dollar business for us worldwide, seven plus billion-dollar business worldwide, that's been strong. So that's not promotional, that's just better margins in some cases.

Q - Scott Mushkin {BIO 7138867 <GO>}

Okay. So, then, I wanted to talk a little bit more long-term about competition. It's been a long-time I think we've seen with many openings from non-Costco people. You are going to see that over the next year, two, three. The other competitors also, they tout their omnichannel and their technology about scanning and going, just give us an overall year view of the competitive environment over the next one to three years and how Costco fits and what you think of some of these technologies and e-coms stuff are competitive advantages for people that are our competing against you.

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

Well, I think we're fortunate in one-way that first and foremost, the biggest value attributor, customer attraction attribute is the best quality goods at the lowest price, and we dwarf everybody in that regard. I mean our average mark up of our goods is in the low double digits, 12%, 13%. You know what they are at other traditional retailers, anywhere from 25% to 35% to 100%, so we have that extreme benefit to start with. Arguably, we've been somewhat simple in our own arrogant way over the years. One of the things we've done is, as I mentioned earlier on question that John, I think had, on to get about personalization even Target marketing, I view it now as some low-hanging fruit that we're finally get around to do over the next couple of years. So that'll be a positive to us relative to others in terms of the benefit of buying online and picking up in-store and things like that, we frankly view that it is more costly than it is beneficial, and again, we haven't been asked a lot about it other than by analyst to who are responding in fairness to the different retailers that feel they have to do it, many of them want to do it, but there's a cost to doing that.

So we feel pretty good about driving business. We think we can do more -- we can certainly do more online. We don't have some strategic goal to go from 8% which is still a $20 billion business that we go from 8% of sales to 16%, but let's go from 8% to 9%, 9% to 10% to 10% to 11% over a certain period of time. And we think that with some of the things we're doing on that side, we can. I think we've also done an incredible job day-in and day-out on the merchandising side of bringing in more exciting items and that's something that is focused on that I hear about it every budget meeting and every Monday morning meeting with Greg and Ron and the few other senior colleagues including our merchandising head. So, I think that's what's going to keep driving our business. I think we are getting better on the technology side. Playing from behind a little bit on that, but I think we finally got a game plan and some people that are helping build those areas up, both from a marketing and advertising standpoint. Taking advantage of the advertising dollars that are out there that we've done pretty well despite ourselves, but we know we can do a lot better in grabbing some of those dollars and what will we use it for is to drive sales.

Q - Scott Mushkin {BIO 7138867 <GO>}

In the club openings, I don't think you touched on that. Thank you

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

The big club thing is we run our target. I think, for the last three years, there was a big down here because of the year for sure, COVID, but fiscal '21, '22, and '23, I think we averaged around 23 net-new units a year in '22, '23. We'd like to get above 25 over the -- each of the next five years and closer to the 30, years six years to 10 years, that's kind of the game plan and that really is a bottom-up approach by each of the eight US geographic regions, the two Canadian regions and every other country region, working with operations in our real-estate department, kind of which ones are likely and what's our priority in. We feel pretty comfortable, we've got a good pipeline of pending openings for sure over the next three or four years and with equal level of comfort that we feel that we'll continue to have plenty of opportunities to open units.

Q - Scott Mushkin {BIO 7138867 <GO>}

Thanks.

Operator

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

Q - Brandon Cheatham

Hey, Richard. This is Brandon Cheatham on for Paul. I want to follow up on what you mentioned about the digital investments that you all are making. It sounds like it's something that eventually you might monetize partnering with your vendors, how do you balance that with your view that you really want your numbers in the warehouse and how do you see that working kind of over the long term?

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

Well, first of all, as part of that monetizing a digital is in warehouse. We've been very successful in moving the needle if you will on a holiday weekend with hot prices on strip stakes or at the beginning of the season with the planting season with green items. And so, I think it's just we're getting around to doing a better job of it and we're bringing in people that we they've done it before, frankly. And that's even in Membership Marketing, Sandy Torrey [ph], who heads-up Membership Marketing, we're doing more things than we're doing -- she is more thing today than we did even a year ago, trying some things. And again I think that our first order of business is to drive business in-store, certainly driving online as well, but not to just replace what's in-store. And so, I think again -- I tried to stay a little low-key on this subject because we're not -- I hate to use the word this new strategic effort, but what we've learned over the last few years is everybody is a technology company today and there's some things that we have been a little slow to doing and we know there's a lot of opportunity there to do some of that even basic things, not how you get five emails a week that none of which relate specifically to you. If it was an email, even just based on a couple of items you purchased in-store that had a banner of items that you might be interested in you can literally double the click rate on them. So those are the kinds of things that bring in on the floor, what we call Catalyst, VP hires in our IT department over the last few years. One is data analytics and one is digital. And that it's not just two individuals, it's the teams that they have built in short order. So we'll continue to do that and tell you more as we go along.

Q - Brandon Cheatham

Got it. And if I could follow-up on the membership side, you mentioned Membership Marketing, are you seeing any difference in promotions from your competitors for their memberships, how is that informed or what you all are doing and is there any major change on promotions or membership from your competitors?

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

Well, there's really no change. I mean, we do a few promotional things each year, but the biggest thing we don't do is in any big way discount our membership. Now some of the promotional things that you may sign-up for membership and you get certain number of coupons related to stuff, but I don't want to go into that, but you can look at our competitors and see what they do. There's a lot more promotional activity going on elsewhere and we're still getting, as I mentioned on the call, a year-over-year 7% increase in new memberships with about a 3% --just under 3% increase in number of new warehouses. So we're still getting people indoor. I think in fairness that's been helped by COVID. When we were one of the -- we being warehouse clubs was a big cavernous place to come and get a lot of things and that's certainly helped us. I'd like to think we're pretty good at what we do and that's why more people are signing up and we're opening new units and driving more business that way. So -- but really we have not done -- if anything we've done a little less on the promotional side and membership, we do a few promotional things each year, but not a lot.

Q - Brandon Cheatham

Got it. Thank you.

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

I'm going to take one more question.

Operator

Your next question comes from the line of Rupesh Parikh with Oppenheimer & Co. Your line is open.

Q - Rupesh Parikh {BIO 15915617 <GO>}

Good afternoon, and thanks for taking my question. So on China, I was curious with the reopening there, how those locations are performing versus your expectations?

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

They are doing great. And the story, we've been blessed by those first openings that we have over there. We were impacted like everybody over there during the shutdown and what have you and we had some great video clips at our budget meetings here showing what we did to create care packages, not only for our members but for the neighborhoods around us and we were told they were the best care packages of any of the big retailers, so that made us feel good.

Q - Rupesh Parikh {BIO 15915617 <GO>}

Great. And then maybe just one follow-up question. As you look at your bigger ticket categories, consumer electronics, et cetera, any sense at this point whether trends have bottomed or just curious if you're trying to monitor whether we could see further softening in some of these bigger ticket areas?

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

I have one of my colleagues here in merchandising side and she was saying to me softly, the negatives are getting better (multiple speakers) it's about seven months or eight months ago -- seven-ish months ago when we started to see the decline and so if nothing else we'll be having an easier compare five months sense, but it's certainly we've seen a little bit of improvement in the negatives. Well, thank you, everyone.

Q - Rupesh Parikh {BIO 15915617 <GO>}

Okay, great. Thank you.

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

David, Josh, and I are around to answer your questions if you have any more, which I'm sure you will. Have a good afternoon.

Operator

This concludes today's conference call. Thank you for your participation, you may now disconnect.