Costco Wholesale Corp. (NASDAQ:COST) Q3 2016 Earnings Conference Call
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Executives

Richard Galanti – Executive Vice President, Chief Financial Officer

Analysts

Steven Zaccone – Cowen and Company

Simeon Gutman – Morgan Stanley

Matthew Fassler – Goldman Sachs

Matt Lasser – UBS

John Heinbockel – Guggenheim Securities

Mike Montani – Evercore ISI

Peter Benedict – Robert Baird

Bob Drbul – Nomura

Paul Trussell – Deutsche Bank

Scot Ciccarelli – RBC Capital Markets

Operator

Good morning, ladies and gentlemen. My name is Karen and I will be your conference operator today. At this time, I would like to welcome everyone to the Q3 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I would now like to turn today's call over to Mr. Richard Galanti, Chief Financial Officer. Mr. Galanti, you may begin.

Richard Galanti

Thank you, Karen and good morning to everyone. Before I begin, please note 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 results, events 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 we do not undertake to update these statements except as required by law.

Last night's press release reported our third-quarter and year-to-date fiscal 2016 operating results for the 12 and 36-week periods that ended this past May 8. For the quarter, our reported earnings per share came in at $1.24, up 6% over last year's third-quarter earnings per share of $1.17.

In comparing our third-quarter results year-over-year, there are a few items of note. As usual, FX as compared to a year ago, during the quarter, the foreign currencies in the countries where we operate weakened overall versus the US dollar, primarily in Canada, Mexico and Korea.

This resulted in our foreign earnings in Q3 when converted into US dollars for reporting purposes being lower by about $15 million, or $0.03 a share than they would have been had the various foreign exchange rates versus the dollar been flat year-over-year.

Gross margins. On a reported basis, it was higher by 34 basis points. This included a $19 million benefit from nonrecurring legal settlements. This represented 7 basis points of margin improvement, or about $0.03 a share.

Number three, our co-branded credit card transition in the United States. With the transition to our new co-brand Citi Visa card next month, co-brand AMEX credit card sign-up stopped, as you know, late last calendar year, I think in October, November.

The short-term negative earnings impact of the lost co-brand credit card sign-ups in the quarter year-over-year was about $11 million, or $0.02 a share to the negative.

We expect to have the new co-brand Visa cards in the hands of our members by the end of May, early June, some of you may have already received them in the mail - with a go live transition date of Monday, June 20.

Number four, wages. As I mentioned on last quarter's, second-quarter earnings conference call back in March, in addition to the - we do a top-of-scale increase each year, which we generally again have done every year each March.

This year, we also increased our bottom-scale hourly rates in the US and Canada, which is about 80% of our company. Effective this past March 14, we increased our starting wage at $1.50 an hour to $13 and $13.50 an hour.

The new bottom of scale wage increase results in a year-over-year incremental payroll expense of about $6 million, or $0.01 a share in the quarter. We estimate that this will be anywhere from $0.01 to $0.02 a quarter in each of the next three quarters depending on which way it rounds.

Number five, IT modernization. IT modernization efforts negatively impacted SG&A expenses in Q3 on an incremental year-over-year basis by about $16 million, which is about 5 basis points, or $0.02 a share to SG&A.

I believe in the first and second quarters this year that year-over-year delta of modernization expense was 7 basis points to the negative in Q1 and 3 in Q2. So it looks like it's averaging around 5 a quarter for the first three quarters of the year.

LIFO. This year in Q3, we picked up a little bit there from a LIFO credit. We recorded a pretax LIFO credit of $13 million in the quarter. Last year, it was also deflationary, but as you know deflation has continued. It was $7 million, so again about a $6 million, or a penny a share delta there. Those are the items I'd point out.

Turning to our third-quarter sales, total reported sales, as you know, as reported, was up 2% and our 12-week reported comp sales figure was flat or zero. Sales, of course, were negatively impacted by gasoline price deflation.

That was almost 2 percentage points impact and about 190 basis points and by the weakening foreign currencies relative to the dollar that I just mentioned. That was about 145 basis points.

So excluding gas deflation, the flat US comp number we reported would have been a plus 3%. In Canada, the plus 1% reported Canadian comp would've been a plus 8% in local currency, excluding gas deflation and flat FX rates. And the reported minus 2% other international, excluding gas deflation and assuming flat over year FX, that would've been a plus 3%. So all told, our reported zero comp for the quarter, ex-gas and FX, would have been a plus 3%.

In terms of new openings, in the quarter, we opened 7 new locations and also completed one relo. So year-to-date for the first 36 weeks, we've opened a total of 19 new warehouses and 3 relos. For all of 2016, we have a current plan of 29 net new locations; a little over two-thirds of them, 21, will be in the US; two in Canada; two in Japan; and one each in the UK, Taiwan, Australia and Spain.

This morning, I will also, of course, review with you e-commerce activities, membership trends and renewal rates, additional discussion about margins and SG&A in the quarter and a couple of other items.

So going down the P&L, again, for sales. Total sales were up 2%. Reported comps flat. Reported, up 3%, excluding gas and FX. Now the zero flat comp on a reported basis was a combination of an average transaction decrease of a little under 3%, minus 2.7%, on a reported basis.

And again ex-gas and FX, the average transaction increase would've actually been up 0.5%. And the average shopping frequency increase was up 3% for the quarter, which is most of February, all of March, all of April and a little of May.

In terms of sales comparisons by geography, in the US, Texas, Midwest and South East regions were the stronger ones. Internationally in local currencies, better performing countries were Mexico, Canada and the UK.

In terms of merchandising categories for the quarter, within food and sundries, which was overall flattish year-over-year, sundries, foods and meat, deli were the leaders. Tobacco, as I think we mentioned a little bit on the April sales call, was negative in the low teens as we continue to eliminate tobacco from various locations.

For hardlines overall in the mid-single digits. The departments with the strongest results were sporting goods, toys, seasonal, automotive, consumer electronics and garden/patio. I think I will have to go look at what was down because those were all pretty good departments within hard lines.

Within low to mid-single softline comps, single-digit softline comps, small electronics, men's apparel and home furnishings were the standouts. And lastly, in fresh foods, comp sales overall in the low single digits. Produce and deli showed the best results. Of course, we probably had the most deflation I think in the meat, poultry and pork areas.

In the US, we continue to see deflation in the low single digit range for food and sundries, and as I mentioned fresh foods, and a little in some of the non-food areas as well, notably electronics.

Moving down the income statement, membership fees came in - in dollars were up 6% and up 7 basis points as a percent of sales, coming in up $34 million from $584 million last year to $618 million.

Again, FX currencies, exchange rates impact this number. Without FX, we are assuming flat year-over-year FX. The $618 million would have been up $7 more million and so the 6% dollar increase year-over-year would have been up 7. Same number of basis points, of course, up 7.

In terms of renewal rates, we continue at strong renewal rates, 90% plus in the US and Canada, 88% worldwide. Continue increasing penetration of the executive membership and I will talk about that in a second.

New member signups in the quarter companywide were at 15% year-over-year in part driven by strong sign-ups at our new openings in Taiwan and Japan. The Asia openings always have outsized new sign-ups. We also had very strong sign-ups in Tulsa, for that matter. Overall, in the US, in fact, it was up 15% as well.

In terms of number of members at third quarter-end, Gold Star was 36.2 million, up from 12 weeks earlier at 35.4 million; primary business, the same at 7.2 million; business add-ons, the same at 3.5 million at the beginning and the end of the quarter. So all told, 46.9 million member households, up 800,000 from 46.1 million at Q2 end.

Total cardholders is 85.5 million, up 1.5 million from 84 million at the end of the second quarter. I mentioned executive memberships. We came in at the end of Q3 with right at 17 million executive members, which is an increase of actually 402,000 over the 12 week period, or 33,000 a week increase in the quarter.

I think that tends to be on the high end of that weekly increase in many of the last recent quarters, executive members are approximately 36% of our member base and about two-thirds of our sales and continues to improve penetration.

In terms of renewal rates, business members were 94.4% at the end of the quarter, tweaked down from 94.5%; Gold Star, 89.6%, a tenth down also, 89.7%; and so total US and Canada, 90.4%, down from 90.5%, worldwide, at 87.6% at the end of the quarter, again a tenth down as well.

Within the US and Canada, of course, we've seen a bigger tickdown than a tenth of a percent in Canada. That has to do with as we anniversary now about 18 months when we initiated the change in credit cards up there, which was actually everybody having to sign up again.

So I think part of that is the auto renewal. We see a little of that in the US since we haven't been adding on, accepting new applications for the current co-branded credit card since past October, but pretty much in line with what we thought.

In terms of gross margin, our reported gross margin, as I may have mentioned, was up 34 basis points, 11.43% this year versus 11.09% last year. And as usual, I will ask you to jot down four columns of numbers to provide a little edification here. The four columns would be Q2 2016. Columns 1 and 2 are both Q2 2016.

These are year-over-year changes in basis points. First column would be reported figures for margin. Second would be without the impact of gas deflation since that tends to distort the numbers wildly. And then columns 3 and 4 would be Q3 2016 both reported and in column 4, Q3 2016 without gas deflation.

In terms of the line items, the first line item going across would be core merchandising, so Q2 2016, we reported a plus 5 basis point year-over-year. Ex-gas deflation, it was minus 3. In Q3, reported, plus 16 and ex-gas, minus 2, ancillary, a plus 9 and a plus 7. And then columns 3 and 4, a plus 9 and a plus 4. 2% reward, minus 1 and 0.

And in Q3, reported without gas, 0 and plus 2. LIFO in the second quarter, plus 4, plus 4; in the third quarter, plus 2, plus 2. Other, 0 and 0 in the first two columns and a plus 7 in columns 3 and 4, that's those nonrecurring legal settlements I talked about earlier.

You add up those columns reported in Q2 year-over-year, we had an up 17 basis point margin and up 8 on an ex-gas deflation basis. And again, as well, we reported a plus 34. It's a plus 13 ex-gas deflation.

In terms of the core merchandise component, which again reported plus 16, but minus 2, if you look at the four key categories, which is 80% plus of our business, food and sundries, hardlines, softlines and fresh foods, as a percentage of their own sales, they were positive year-over-year by 16 basis points with food and sundries, hardlines and softlines all being up year-over-year and fresh foods being slightly down during the quarter year-over-year.

Ancillary and other business -- by the way, those numbers exclude the non-recurring items that I mentioned -- ancillary and other business margins were up 9 basis points, up 4 without gas and within the quarter on their own sales, gas, optical and hearing aids all showed higher gross margins year-over-year as a percent of their own sales.

I mentioned LIFO already. That was a 2 basis point benefit year-over-year and other, again a 7 basis point improvement year-over-year. So even ex that on an ex-gas deflation basis, margins were up a few basis points year-over-year.

Moving down to expenses, SG&A. On a reported basis, were higher by 33 basis points coming in at 10.44 compared to 10.11 a year ago. Again, we will do the same four columns, Q2 reported and without gas and then Q3 reported and without gas.

Core operations, minus 22 reported year-over-year and a minus means higher year-over-year. Ex-gas in Q2 was a minus 16. Columns 3 and 4, minus 24 and minus 8. Central in Q2 was a minus 8 and minus 7; Q3, minus 6 and minus 4; stock compensation, minus 4 and minus 4 and then a minus 3 and a minus 2 and no quarterly adjustments.

So all told, we reported year-over-year in Q2 SG&A higher by 34 basis points on a reported basis and 27 ex-gas. This quarter Q3 reported higher SG&A by 33, 14 higher ex-gas.

Basically within the -- if you go back to the core operations or operations, the ex-gas deflation, the 8 basis points year-over-year higher, that consisted of higher payroll and benefits year-over-year, which impacted that minus 8 by minus 12, so more to the minus 8.

These items were somewhat offset by a variety of other controllable expense items. Q2 is of course always the lowest volume quarter and of course, as we know, sales were a little weaker for a variety of reasons, including some inflation.

Central expense was higher year-over-year in the quarter by 6, ex-gas by 4. IT is the 4 on an ex-gas basis. It was minus 5 on a reported, but essentially ex that. Central did a pretty good job in the quarter purchasing that. And again, stock compensation expense, no surprise there.

Next on the income statement, pre-opening, a little higher year-over-year, $18 million for the quarter versus $14 million a year ago, so up by a basis point. This year in the quarter, we had 8 openings, including one relo.

Last year in the quarter, we had 4 openings, including 1 relo. Again, some of that is not necessarily related to those specific openings as it may include some right before the quarter opened as well. All told, operating income came in at $858 million for the 12-week quarter, up $37 million, or up 5% year-over-year from last year's $821 million.

Below the operating income, interest expense, interest expense came in at $30 million this year versus $31 million a year ago, essentially flat, no surprises there. Interest income and other this year was $7 million, lower by $2 million versus last year's $9 million.

Actual interest income within interest income and other was essentially similar year-over-year at about $10 million; the balance of that delta was year-over-year it was the other category coming from small foreign exchange adjustments and slight year-over-year changes in whatever other is, other earnings. No big surprise there.

Overall, pretax income was higher by 4.5%, or $36 million, coming in at $835 million, up from $799 million a year earlier. Our tax rate was a little lower or better year-over-year coming in at 34.2%, down from 35.0% last year in the third quarter.

Basically, this year's third-quarter income tax percentage benefited from again just a few positive discrete items in the aggregate going our way. That's why it was a little lower. Our normalized rate is actually just a shade over 35% in both of those quarters.

Overall, reported net income of $545 million for the quarter compared to last year's $516 million or up 5.5%.

For a quick rundown of other topics, typical topics -- well, the balance sheet is included in the morning's press release. A couple of balance sheet info items that you may not see on there: depreciation and amortization in the quarter was $291 million and $847 million year to date.

Accounts payable as a percent of inventories, on a reported basis it was 99%, a percentage point lower than a year ago at 100%. That of course includes non-merchandise payables, such as construction payables, same kind of delta. The 99% reported this year would have been at 89%, the 100% would have been at 90%, so again right around the same year-over-year.

Average inventory per warehouse was actually down about $0.5 million, or down 4%. About a third of that is FX, so almost exactly a third, $173,000 of $516,000. The rest is pretty much spread across many categories, including the impact from deflation.

If you assume, and again, you never know exactly what the deflationary cost amounts are, but if you assume a 1% deflation, you get somewhere about half of that remaining being gas and the rest being just a little lower inventories, but, again, lower year-over-year by about $0.5 million.

In Q3 in terms of CapEx, we spent $460 million during the 12-week period and essentially year-to-date we are right at $1.8 billion. I would estimate for the year we will come in at around $2.5 billion to $2.7 billion compared to fiscal 2015 total expenditures of $2.4 billion. So up $100 million to $300 million from a year ago based on whatever timing we have left here and what expenditures are made.

In terms of Costco Online, as you know, we are now in six countries -- US, Canada, UK and Mexico, plus the recently launched countries of Korea and Taiwan. In the quarter, sales and profits are up. Sales were up on a reported basis 14% in the quarter, up about 15.5% ex-FX. On a comp basis, that would be 13% and 14% ex-FX.

In terms of expansion, again, I mentioned in the quarter that we are in now, which is a 16-week quarter, we would expect to open 10 new openings plus 1 relo, and again, that would put us at 29 net new openings, 33 openings, but 4 of those were relos, so 29 overall.

In fiscal 2015, we added 23 net new units on a base of 663, so about 3.5% square footage growth. In 2016, the 29 on the new base would be about 4.5% square footage growth, slightly lower unit growth, but you tend to open a little bigger unit since you've got the relos as well.

New locations by country again, 21 in the US, 2 in Canada, 1 each in the UK, Taiwan, Australia and Spain and 2 in Japan. As of third quarter-end, our total square footage was right above 100 million at 100.7 million square feet.

In terms of stock buybacks, if you recall in Q1, we repurchased $130 million of our common stock; in Q2, $80 million. Both of those are, of course, 12-week quarters as well and in the 12-week third quarter, we purchased $136 million such that year-to-date we've spent about $346 million with an average price per share of $148.64.

If you annualized those quarters, and again, we will see what we do this quarter, but if you annualize it, we are right at $0.5 billion for the year. We'd be right at $0.5 billion for the year. We will see where we come out.

In terms of dividends, as you know, last quarter, we raised our quarterly dividend rate year-over-year to a quarterly amount of $0.45. I believe that was up from $0.40 for the prior year each quarter. That $1.80 a share annualized dividend represents a total cost to the Company of around $790 million.

Before I turn the call back to Karen for Q&A, I want to mention a slight timing change each quarter when we report our quarterly results. Many of you have asked about the fact that we report earnings the night before, usually around 6:00 Pacific time, then you've get to wait until the next morning to hear the call.

Beginning with our fourth quarter earnings release, we are going to change the timing of that release and the conference call such that, for the fourth quarter, we will issue results after the market closes on Thursday, September 29, followed up shortly thereafter with a live conference call that afternoon and a Q&A session at the end of that call.

This new schedule will be our plan for earnings releases going forward and I think it'll be helpful and certainly in response to several of your comments out there.

The last quick item, next week, we report the four weeks of calendar May sales. This is the four weeks ending this coming Sunday, May 29. I will mention to you that, based on how Memorial Day falls year-over-year, this year, Memorial falls on day one of the June retail calendar month, so this year, we have 28 days versus last year's 27 days. So that will be a little benefit. Again, we'll all point that out.

June, there's really a wash. You've got a detriment related to Memorial Day. You've got a date pick up on the other end of June with how July 4 falls, and then finally we will get through that silliness in July where we report July sales.

With that, I will open up to Q&A, and I will turn it back to you, Karen.

Question-and-Answer Session

Operator

[Operator Instructions] And your first question comes from the line of Oliver Chen of Cowen and Company.

Steven Zaccone

Hi. Good morning. This is Steven Zaccone on for Oliver Chen. Thanks for taking our questions. Just two questions from us. Firstly, we wanted to get your take on the health of the customer base for you.

There is been some different trends among retailers reported thus far in earnings. Wanted to just get your sense have you seen any changes in trends or spending habits?

Second question, just wanted to get your thoughts on progress with some of the third-party partnerships in grocery delivery. How has growth in those channels performed relative to expectations and then just thoughts about expanding into new markets? Thanks very much.

Richard Galanti

Okay. Well, in terms of the customer, so far so good. We don't see any dramatic change. Many of you have asked questions or have had some concern about traffic coming down from this 4% plus number over seven years. We feel pretty good about where our numbers are. We don't really see a lot of different changes.

Interestingly, when you look at nondiscretionary items like food and sundries versus discretionary items across the nonfoods categories, including big-ticket items like furniture, electronics and the like, we've actually had, relatively speaking, a little more strength in some of those nonfood categories. So that I think allays some of any concerns that some people have had.

But generally speaking, I'd have to say our customers are still pretty healthy and we are still getting good renewal rates notwithstanding a very small impact from some of the credit card transitions and so we feel pretty good at this point about that. And certainly I feel good about some of the merchandising stuff that we've got going on.

By the way, one of the other data points I've been asked several times in the last few weeks each time we've reported sales in the last couple of months is is it deflation, is it weakness, is it dotcom, whatever.

The fact of the matter is, if you look at during the 12-week quarter on a year-over-year basis, if we just take the average items per unit in the basket going through the front end, US only, so US only, it was up 1.4%. So we are getting people to buy more items, if you will.

The average basket value is up 0.4%. The simple implication there is you've got deflation presumably -- deflationary pressures of about 1%. Now that's a good educated guess. There could be other impacts of sizes, but typically we go into bigger sizes, not smaller sizes and bigger pack sizes.

So I think overall there's probably still a little bit more deflation that we've seen over the last couple of quarters spread to other items in the nonfood category as well as we've seen.

In terms of third-party partnerships, we are pretty agnostic. We have good relationships with Google in regard to Google Shopping Express. We have Instacart, of course, Google's, in six large communities in the country -- the Bay area, the LA area and a few others and Instacart I think is now in well over 15, maybe even 20 markets where we participate with them, and also a few of the others out there.

In terms of expectations, we didn't know what to expect. I believe that we generally are the anchor tenant, if you will, in many of these opportunities where there is more than just Costco items being purchased and sold just to provide to the end consumer, and so we think it's been good.

It's still small relative to -- we still want you to come into the warehouse and we are going to still figure out how to continue to do that, but it's growing nicely and it's certainly on a small scale a bit of a help.

In terms of expansion plans, I think you asked about openings, looks like our goal is still similar next year, about 30. We will shoot for something a little over 30 and end up about 30 if history repeats itself.

We probably had a few more relative to that 30 number, a few more in the US this year than we would have anticipated if you would have asked me a few years ago. I think some of that is timing.

We've had success in the US and probably the expectation of some of the markets we've gone into in the last couple of years, if you asked me five years ago, would we be going into some of these markets where we have never been in and our competitors have been in for up to 30 years.

We've had success in those markets, whether it's Mobile or Tulsa or Toledo or Rochester and New Orleans, and so probably there's a few more in those markets on top of the few that we opened like whatever [indiscernible] number we have in the Puget Sound or LA, where they are harder to find because we are very specific locations to fill in markets. So I think that's probably one thing.

Looking at the 30 next year, and this is a guess, it's probably not two-thirds, not 21 over 29. If I had to guess, it's probably a little less than half, 50%, 52%. And again, that's a guess at this point.

Steven Zaccone

Thanks very much.

Operator

And your next question comes from the line of Simeon Gutman of Morgan Stanley.

Simeon Gutman

Good morning. Simeon Gutman. Richard, the Visa transition besides the timing that started a little later, anything else to think about? Interchange fees probably start to go down when it happens, but are there other costs that make your SG&A or any other line items elevated temporarily?

Richard Galanti

No, same old stuff that we've talked about in terms of some of those things like having not signed up new co-branded cards since last October, November. There's part of any of these equations are different pockets of income, including generating new sign-ups, new credit card sign-ups and that's been about 4 million to 5 million a month, which is easy. It used to be something and now it's nothing until June.

Other than that, no, we've just got a lot of people on our side and on the issuer side doing a lot of work to make sure it goes as smoothly as possible and we are excited about it. It's a great reward for our members improvement wise and we will keep a little of it ourselves in terms of merchant fee reduction and really there's not a whole lot – yes, cards are hitting right now in fact.

They will continue to hit, when you've got literally over 10 million pieces of mail going out, it's spread over a few week period, and I think they just started hitting. So cards should be in everybody's hands a few days to a week -- at least a few days to a week before the June 20th D day here.

And we will be able to tell you more in September on the -- late September when we do the fourth quarter earnings call, but again we are ready to go and we are excited about it.

Simeon Gutman

And then the marketing dollars, the in-store kiosks, like you said the mailing, that's -- we are not going to see a blip good or bad in the SG&A dollar run rate? There's nothing unusual that should happen as we sequence there?

Richard Galanti

Absolutely.

Simeon Gutman

Okay. And then my follow-up on gross margin, I think you mentioned that looking at I think it was the gasoline with the optical business, I think you said it was higher year-over-year and if that's the case, can you explain I guess how you are doing -- I thought we were cycling the hump of some of the best performing gasoline gross margin quarters a year ago. Maybe it was the mix of optical, but figure that gas is a bigger input.

Richard Galanti

Yes, it will come in Q4. This quarter was an odd quarter. It ended up being -- in the first part of the quarter, it was better than we expected and with gas prices going up and down -- going up right now, it's been a little weaker the last couple weeks, but it was probably a little stronger near the beginning and into the middle of the quarter than we had anticipated, and it's generally two things.

I think the bigger factor is, is when there's daily price changes up and down in the cost of -- procurement cost of both us and other gas station operators and then when it goes down, we seem to feel that we get a little extra margin in part because our competitors don't give as much back as fast as we do.

So we still give way more back and it helps us a little bit. And so I think part of that new normal, if you will, over the last couple of years in that regard, it's probably on average a little better.

Simeon Gutman

Okay, thank you.

Richard Galanti

You will see it in Q4 though. I say that today. Day-to-day sometimes it changes relative to what -- just when we think we are smart and it's safe to go out, it goes the other way. But so far I guess it'll impact us in Q4.

Simeon Gutman

But in Q4 being the hump and then it gets easier after that?

Richard Galanti

Yes.

Simeon Gutman

Okay, great.

Operator

And your next question comes from the line of Matthew Fassler of Goldman Sachs.

Matthew Fassler

Thanks a lot. Good morning, Richard. My first question relates to margin. Can you just talk about the degree to which moving food prices, I guess a deflation issue, and/or FX would've contributed to margin rate in any way?

Richard Galanti

Well, the only thing that FX does is -- needless to say, in most other countries, some of their goods are US-sourced or US-dollar payable. In Canada, it is substantial, frankly. And we manage that and we lock in, you know, in a way natural hedges during the quarter once the buyers are comfortable with that exchange rate and what they're going to be able to price it at.

But my guess is they are still - when you've got - when you look at, let's say in Canada year-over-year the Canadian dollar is 17% weaker, incrementally just in the quarter 5% weaker from the previous month. So you've got that kind of stuff going on from the previous quarter.

You are going to have probably a little margin pressure there. Notwithstanding the margins are up a little. I think generally we try to bring down prices when there's deflation and probably doesn't impact us as much because -- it impacts us a little sooner than others and that's pretty much it.

Matthew Fassler

Got it. And then LIFO, I guess, it's I think the seventh consecutive quarter where this has gone your way and I know you market to the best of your expectations at the end of every quarter.

How much of this is food, and if we think about commodity prices, I know once again this should be zero in a normative environment. Any sense of whether there's more momentum that could prove helpful to you here?

Richard Galanti

I don't think -- again, deflation from the end of the year is down about 0.8 [ph] of a percent in terms of a LIFO index. And the other comment I made, it was about 1%. Ask the question again. I was looking at one thing. Go ahead.

Matthew Fassler

I guess the question is how much of the movement in LIFO, the ongoing credits, relate to food and based on commodity prices that you see, any desire to venture a guess as to where LIFO goes next?

Richard Galanti

We don't know. If you talk to our fresh foods buyers, they are continuing to expect some deflation. I get different answers from some of the non-foods buyers. Mind you, when we look at fresh foods year-over-year, those margins were down slightly in the low double-digit basis points year-over-year, so again not a big impact there.

It's the other categories where it was up a little bit, and so the net of all those four main categories, it was up 16 basis points. I don't think there is lots...

Matthew Fassler

And then, finally, any sense thinking about the very long run about whether your food -- how your food market share moves if at all when prices are deflationary and perhaps consumers see some of the prices that they had only seen at Costco for a long time at other retailers?

Richard Galanti

Well, first and foremost, I think we continue to believe that we will continue to see increasing penetration of the stuff we sell in fresh foods. Nobody doesn't like us. The quality levels and the values are awesome and some of the things we are doing with global sourcing initiatives and poultry plants and organic -- our pounds in beef are way up, but you've got deflation in beef more than some of the other protein categories. We are the first to go down in some of those items when there is deflation.

So I think our numbers have actually -- the deflation in some of the fresh food categories I think mask some of the pound strength, if you will or the unit strength that we have whether it's protein or produce. And I would never be so arrogant to say that nobody can catch us, but we've got some great things going on in terms of again global sourcing, working with vendor partners.

And we looked at our produce today, which is I think a $6 billion business now, approaching a $6 billion business, which is as big as protein. I don't think many retail food places do those kind of numbers.

And so I think it has more to do with that than, yes, there's probably going to be a little bit of a macro shift, whatever. I think what we do and how we do it dwarfs those other impacts.

Now there's other players coming into the market. I think just this week you've got a 365 opening and you've got other people coming to town with different health-related organic-related types of retail formats.

We are pretty good at that stuff too and again, you've got to like bigger sizes, but we are pretty awesome in the fresh area and I think that will continue to -- should be for us an increased sales penetration area and something that'll keep driving our members...

Matthew Fassler

Thank you so much. Appreciate it. Thanks, Richard.

Operator

And your next question comes from the line of Matt Lasser of UBS.

Matt Lasser

Thanks a lot for taking my question. Richard, you sized the P&L impact of the credit card transition at $11 million. Presumably, that's just from lost sign-up -- credit card sign-ups. Are you able to tease out any impact from spending as a result of this transition?

So for example, maybe some of the holders don't know that they can still use their card and so they put it away and that changes their behavior...

Richard Galanti

There's always going to be a little confusion. To the extent that we haven't signed up new co-brand credit card members, I don't think many members -- many people coming into sign up for a Costco membership have walked away because we don't -- they can't sign up for the new AMEX card.

If they have an AMEX card in their wallet, they can use that one. Now, to the extent that they don't have an AMEX card in their wallet, or to the extent that they -- keep in mind, not everybody that signed up for one over the last 16 years got it. It was still a credit eligibility decision that the issuer made and it'll be that way in the future.

The fact of the matter though is is that, to the extent that they signed up as a member, and again I don't think it was that impactful, somebody walking away because they can't get an AMEX card, they have to use a debit card in their wallet or cash or check.

Now, on a macro basis, does that impact some of the big-ticket items? Yes, it probably does. Although our TV sales have been pretty darn strong. So I can talk out of both sides of my mouth on this one.

Matt Lasser

So does that mean that some of the comp slowdown just may be a function of the law of diminishing returns mass taking over?

Richard Galanti

It could be. Again, the ones we can quantify easily we look at. We can drive ourselves crazy. We know that -- let's face it, in April sales when we tried to -- when we shared with many of you on our audio, it's everything. It's deflation, it's a little of the AMEX. Maybe it's getting closer to the line of maximizing marginal whatever.

At the end of the day, we are still rolling out gas stations. We are still rolling out some of the ancillary businesses. We are still opening up new warehouses. We are expanding fresh foods as we have over the last several years.

People ask us about what are some of our new areas and certainly what we do with ticketing and executive member services, all those things -- wine and spirits I think we've been surprised by that -- these are all small things, they are all needle movers, but small movements. But I've always said there's lots of little things that help us here.

Matt Lasser

And my last question is, to the extent that you've already seen some of your existing AMEX cardholders clip up their card and switch to Visa, and it's having an impact on your sales, do you think that's going to only intensify as you get closer to the June 20 transition date? So for example, are you seeing even slower trends in base so far?

Richard Galanti

Well, first of all, I don't think anybody's clipped up anything. They still have to use that co-brand AMEX card through June 19, and nobody can actually use the new card even if you got it in the mail until June 20. That's part of our original agreement with our previous service provider. And that's fine.

So all stuff will happen June 20 and beyond. And rest assured there's going to be a lot of stuff happening in terms of our continued communication, of course, to our members, but there's a lot of members out there that don't have chance.

About a little over 40% of our US sales were done on AMEX with I think over two-thirds of that, a little over two-thirds to half of that being on the co-branded card. Some people tend to want Delta points or Starwood points, so they are using a different one.

The same thing will happen with Visa. Our goal is to get that co-branded card, as we did successfully with the AMEX co-branded card, that to be your top-of-wallet card. We think that there's going to be a lot of things that drive that, including the people out there on blogs independently and others that look at what is currently a 3, 2, 1 is going to be a 4, 3, 2, 1, that's huge.

So my personal view is it'll be something that's not going to all hit on day one. Let's get through day one and the transition first, but it'll be something that will continue for a couple to several years.

Matt Lasser

Okay. Good luck. Thank you.

Operator

[Operator Instructions] Your next question comes from the line of John Heinbockel of Guggenheim Securities.

John Heinbockel

So Rich, do you think this 30 annual openings, is that -- certainly you have the people and the capital to do more. Is it a real estate bottleneck, or you are comfortable at that level? Can you go solidly beyond that?

And I think internationally outside of North America as you go into more countries, you would think that there is an opportunity to do 15, 20 a year comfortably. Can you ever get to that level?

Richard Galanti

Well, first of all, it clearly is not capital; we have plenty of capital. I would argue we have too much capital out there. We like it that way. It's people. It is people. Years ago, I didn't depreciate it as much as I do now, particularly in these countries. If you think about in Japan, I think there was an 18-month period a few years ago where we went from 9 to 20 units in about a year and a half, two years.

It's not like we are sending a bunch of experienced warehouse managers to go open and operate and be warehouse managers in Japan from different countries. So you do that a few at the beginning and you may do it occasionally on a onesie basis, but at the end of the day, you are growing from within and developing those local country people.

And first and foremost from an international standpoint, you've got that. That can be a little bit of a challenge, and then you've got things take longer there. There are some countries that I understand are very difficult just because of zoning and restrictions that are in place, not just on us, but any big-box, even local company big boxes in the hypermarket area and the like. So it's going to take a little longer there.

The other thing -- do I think we can go above 30? Look, we shoot for low 30s and then next year we will shoot for mid-30s and you've certainly heard me say that we want to be around 30 and five years from now we should be doing 35. Maybe we will fall a little short of that, maybe we won't. But we've got more feet on the ground real estate-wise in other countries, as well as the US, than we've ever had. It does take a little longer, but we also -- could we physically open more?

Sure, but we like what we do and the way we do it. And probably we also have a comfort level that it's not like we are going to miss out. We are, in our view, the preferred flood out there, and so when we go into a market, if we take a little longer to get there, people are waiting for us. It might be a little harder, but the fact of the matter is is we feel comfortable how we are doing it.

John Heinbockel

And then, as the traffic in the US has moderated, back to what -- maybe you said you were at a level that couldn't be sustained, back at a level that can be, are there discussions internally that it is just a natural moderation, or because you talked about within the categories the 16 basis point improvement in margin that there are things you can do proactively to give more back to the member, and would that do anything to traffic? So that discussion internally about the balance of earning versus trying to maybe drive traffic a little more, can that be done?

Richard Galanti

Well, first of all, first quarter was -- and if you haven't seen this slide before, it's reiterated and put out here internally every day of the year and at our managers meeting, Jim used to and Craig does now, we are a top-line company, we want to drive sales. The fact that margins year-over-year are up on those categories up 16 basis points, we are not smart enough to figure out how to get there all the time. We are always going to drive margin a little bit where we can, but we do it the right way by giving most of any savings back to the customer.

If I look at our competitive stance, our pricing competitive stance, versus our direct competitors, the gap has never been wider. We could make a little more of this, but we don't. At the end of the day, we are always looking for ways to do that.

When we do membership fee changes, historically, we are always looking to give some of that back. So all of those things go into it. But at the end of the day, what helps margins? Private label, fresh food strength, some of the ancillary businesses.

All of those things are helping as well, and again, we feel -- we don't necessarily -- I got to tell you, we don't look at it and say, hey, frequency came down a little bit, or the comp is a new normal or a little bit lower. We want to do more. Even when we were doing a 4% shopping fee, how do we get it higher even though that was kind of tough.

So we are going to continue to do things in that direction and we don't necessarily worry about, well, that came down a little bit so we need an extra few basis points of margin. That's never the case around here.

John Heinbockel

All right. And then, lastly, is KS having any kind of real impact that you can see on basket size or not really?

Richard Galanti

I don't know. We keep adding -- well, we subtract and add KS items, so they live and die by the same metrics. If it's not a great item, we stop it. But there aren't any giant items like toilet paper and water, those types of things or disposable diapers, several years ago, but there are lots of little ones. I think, again, we would see that continue, the increased penetration, but at a slower rate of growth in the future as well for the same reasons.

John Heinbockel

Okay, thanks.

Richard Galanti

I don't think, getting back to your question, I don't think that's a big reason of why the basket size has changed. If anything, many of those items, it's a lower price point. If we are doing brand only and we brought in the – prefer [ph] next to it, in many instances, it may be the same because we go to a bigger pack size. In many instances, you've got a lower price point on the same number of units.

Operator

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

Mike Montani

Hey, guys. This is Mike Montani on for Greg. Thanks for taking the question. Wanted to ask, first of all, Richard, you mentioned that there was obviously a little bit of extra strength maybe in some of the discretionary versus nondiscretionary categories and that was something that gave you comfort that the consumer hadn't changed that much.

Can you provide any updates -- obviously, early on here, but like from May results so far, have you seen sequential improvement in traffic versus even April trend?

Richard Galanti

Well, we really can't talk to anything about May yet. There's no giant surprises in either direction. But, at the end of the day -- and again, the comfort level -- I think I was -- earlier in the call, I was responding to many calls that I received from both institutional investors and analysts out there about the concern.

And again, when we look back at it, and we reported April sales and we said, okay, what are the reasons why it came down a bit, was a little weaker. What again gave us comfort, one little data point of comfort, was the fact that some of those discretionary categories are actually doing a little better than one would have thought given the total number. And so that's about as much as I would read into that.

Mike Montani

Okay, thank you.

Richard Galanti

We will tell you next Wednesday for May.

Mike Montani

And if I could, just to follow up on gas a little bit, could you provide the price per gallon for the quarter and also the comp gallon trends and if there was any material impact to EPS that I may have missed?

Richard Galanti

The price per gallon was down for the quarter 19.7%, basically $2.59 a year ago and $2.08 this year. And what was the last part?

Mike Montani

Just asking about what was the comp gallon percentage change and then also was there any material EPS impact on this quarter and if you could help us size up exactly what we are up against in next quarter?

Richard Galanti

I think year-to-date we are up in the low single digits in terms of comp gallons. Again, the big comparison was it was a year ago when it was really outsized comp gallons up 7%, 8%. I know in April I think a year ago it was 8% in the US, and so that was part of that impact of why sales, in our view, sales were a little weaker particularly in California in April.

Mike Montani

And just the EPS impact, Richard, I'm sorry, on per gallon…

Richard Galanti

It was within a penny or two, really no change year-over-year. I think it might have been a penny.

Mike Montani

Thank you.

Operator

And your next question comes from the line of Peter Benedict of Robert Baird.

Peter Benedict

Hey, Richard. Thanks for taking the question. One on gas and another on a different subject. You've been adding 20 to 30 gas stations a year the last several years. I think your penetration is like 70% across the clubs.

How do we see that going forward, is that pace of growth going to continue? Where do you think you can get the penetration of gas stations call it a few years out?

Richard Galanti

Well, in the US -- first of all, every new unit we do where it's possible, we put in a gas station and we are even doing a few in countries like Japan and Australia, which we hadn't done historically.

We relocated a few units in the US. We just moved Hackensack to Teterboro. The Hackensack became I think our 11th, 10th or 12th business center and the new Teterboro one is a big new Costco with a gas station, with better parking and great.

So if we did three or four -- I don't have it in front of me -- but if we did 4 relos this year, my guess at least 3 of them have gas stations and those three don't. But we are starting to max that out.

In the US, we have -- at the end of the quarter, we had 420 gas stations out of 481 warehouses. In Canada, 55 out of 90. I'm guessing in Canada we still have a little bit more room to grow because we started there later.

Again, in the UK, we had none a couple years ago, now we have 4. Japan we have 5. Spain, 50% of them, 1 out of 2, and Australia, 5 out of 8 I believe. And so again it's not like five years ago in terms of just adding a bunch of gas stations, but it still, I think, moves the needle a little bit.

Peter Benedict

Okay. That's helpful. And then can you take a minute and discuss the senior management ranks at Costco? There's been some turnover lately. Doug, I think his last day may be tomorrow I guess, but just talk about what's going on in terms of transition, future transitions and maybe what changes, if any, these new leaders have implemented. I understand it would be only marginal, but just curious your thoughts on all that?

Richard Galanti

Well, look, you talked about shopping frequency staying at 4% for 7 years. People have stayed for 30, including me. So you are having some turnover, of course. Over the last few years, you've had people that are retiring in their early 70s that have worked together starting 55 years ago at FedMart in San Diego.

But I think from a merchandising and operations standpoint, that's been well thought out. Let's face it, the first big concern was what's going to happen when Jim leaves. I think while we were comfortable here internally, I think we've shown and certainly Craig has shown that the transition and the maintaining of the culture has continued without missing a beat.

In merchandising over the last few years, we've took certain carriers like we used to be with non-foods, which is a combination of hardlines and softlines and Dennis Knapp, who was a senior executive over that and has since retired, we promoted two people and have broken out hardlines and softlines.

In operations, we've made several promotions and changes of people again, typically low-tenured people like they've only been here 20 to 25 years that are going from VP to Senior VP levels on -- I think we've got about 16 Senior VPs of Operations in the US geographically.

Now in terms of Doug, Doug, as you know, has been head of US merchandising and certainly involved in a lot of merchandising beyond that as well. Doug is great. He's leaving for -- no negative issues both internally or with himself, and we are all kind of jealous. He's more on the younger side of the senior management team.

Craig has a plan, but he's looking at a few things and over the next few months, we will be announcing how that changes. But we've got good people in place and we don't think that there's an issue at all there.

In Asia, Richard Chang, who goes back to the Price Club days probably 25 plus years ago, ran operations for Taiwan, was promoted as Senior VP over Asia and we've brought some new people in there as well, new people meaning existing Costco people, of course, from the US.

And so I think we feel pretty good about the change. It's sped up because it was at zero. In the last couple of years, it's been a few, a couple and now it's a few and a few more. But I think we are pretty well-positioned for that. I don't see a big change in what we do and how we do it.

Peter Benedict

Okay, great. Thanks, Richard.

Operator

And your next question comes from the line of Bob Drbul of Nomura.

Bob Drbul

Good morning. I was wondering if you could comment a little bit more around some of the geographic trends that you are seeing and just update us on your thoughts around the trends in California?

Richard Galanti

We pointed out California last month for April because it was -- while US overall again was a little weaker than it had been, it was really California. California is about a third of our US company operations and it's probably a little bit more penetrated gas-wise.

And again, a year ago, we had gallon comps, which not only drives gasoline, but more importantly drives people in the parking lot and 52 or 53 of every 100 come into shop. And so that was where we saw a bit of a distortion, California versus the rest of the US.

I believe there was a -- I don't have the number in front of me -- but to get to a 1, the other US was at a 2 and California was a minus 1, and I'm off by a little bit there, but it is that kind of direction. And so that was a little unusual.

Again, I can't predict what that means for the future, but other than that, there are some markets where -- I think the positive that we see is we've been successful in some of these new medium-size markets.

We had the most new sign-ups I believe in many years in terms of a new market, new medium-size market in Tulsa just a few weeks ago. Through opening day, we had more sign-ups than we've had. Now I'm not talking about Asia; that's a whole different story in terms of sign-up levels.

So again, things look pretty good. I don't know if there's a lot of geographic changes other than the thing we called out on California. I personally believe a lot of that related to some of the gas issues.

Bob Drbul

Got it. I saw that you are doing -- what is it, a pickup truck with GMC in terms of -- and are you getting other vendors that are coming to you to look for marketing opportunities given the success of the business?

Richard Galanti

Well, sure. In the car business, I think last year just in the US, we did just under 0.5 million new cars. We've always done -- when car manufacturers have come out with something new, we could do -- by putting one of those cars in front of our trucks in front of each of our locations and doing some type of extra amount of incentive, we can drive a ridiculously large percentage of those six weeks of sales in that car or truck.

In this case, we've toyed with the idea for several years and talked to all the manufacturers about doing a KS vehicle. A great vehicle with all the bells and whistles and an even better value than you'd get as a Costco member or as a Costco executive member.

So I know we had started and stopped a couple times with a couple different manufacturers. We are pleased with it. We think the manufacture is. The dealers are. And sure there will probably be more in the future, but we will see.

Bob Drbul

Great. Thank you very much.

Richard Galanti

We back those with auto products too. We just keep bringing it to a different level. Why don't we take two more questions?

Operator

Your next question comes from the line of Paul Trussell of Deutsche Bank.

Paul Trussell

Hey, good morning, Richard. Just want to clarify a few things, if you don't mind. First, on the new member sign-ups, I think you said up 15%, certainly international store openings has a lot to do with that, but you are also seeing success in the US. If you can maybe just give us a little bit more detail around what's driving that.

Richard Galanti

Well, I don't know what's driving it. We do a pretty good job of getting people in the door, opening in some of these new markets help. It's just been overall strong. If the US is 15% and the whole company is 15%, where was it down? It was up relative to the 15% of course in the end and places like Taiwan and Spain of course was huge, but it's huge on a base of one. And then it was a little lower in Canada where we had very few new openings.

And Mexico same thing. Mexico last year we had a huge opening on a base of about 34 or 35 units, a huge opening, which had outsized numbers, so we are comparing against that with no new openings this year, same thing in Canada. We had a huge opening in a location there a year ago in the quarter versus none.

Paul Trussell

Got it. And then on core merchandise margins, just wanted to make sure the 16 basis point gain you are referring to, that's kind of the true core merchandise margins on the four categories that compares to the 11 basis points. Is that correct? And then also you made a comment earlier in the call regarding AUR. Is your view of total store deflation around 1%?

Richard Galanti

Well, if I look at my LIFO index -- we don't know exactly. If I look at my LIFO index, which is 70% of our inventory, it's a US accounting principle, from the beginning of the year to now, that's about a percentage point, 0.9 of 1%. If I look at the just the total through the US front-end registers, number of items in the basket was up year-over-year 1.4 percentage points, the average basket was up 0.4 percentage points, so a 1.0 percentage point delta there.

That again I think just affirms that roughly 1% deflationary number on average. But it's educated art, not complete science here. And the margins, the 16, is on its own sales, each of those categories, by each of those four categories sales.

Paul Trussell

Great. Thank you and good luck.

Operator

And your last question comes from the line of Scot Ciccarelli of RBC Capital Markets.

Scot Ciccarelli

Good morning, guys. Scot Ciccarelli. Thanks for getting me at the end here. Richard, can you remind us where you are in the IT modernization investment program, when some of those pressures may start to ease? And secondarily, are there any other investment bubbles we should be mindful of as we think about the next two to three years?

Richard Galanti

IT is the gift that keeps on giving. We started at about 3.5, 4 years ago. As we look at it today, what we thought might take four or so years to do the big chunks of this will take six. As we thought it would cost X, it cost 1.5X to 2X, or whatever it is, which is typical.

Our guess is that it'll still be slightly detrimental in fiscal '17 and actually technically it may be even flat to improved a little in '17, but you've got a 53-week year, so there is a little cheat there.

But generally speaking, flat to up a little in '17, maybe up a little in '18 or flat, maybe down a little. We don't know yet. But we are starting to get to that inflection point and my guess is that inflection point will come sometime towards the end of '17 or into '18.

Keep in mind, these numbers don't assume anything -- this is necessity first and foremost. We believe it will help us in different ways, in many ways, and there will be other things we'll add to it. But the bulk of it, of course, is getting behind us and we will go from there.

Scot Ciccarelli

Okay. And any other incremental expenses that we should be mindful of, like you finish one program and typically there's another one waiting or lurking right behind it?

Richard Galanti

I don't think there's anything big out there that way. We just did the bottom of the scale increase, which is a little unusual, not a big number, but it's $0.06 or so a year. And there's no giant changes coming to healthcare. We still give great health, medical, dental and vision benefits to everybody.

If we increased the sales penetration outside of the US, certain structural expenses help us. Healthcare in the US is easily 20 to 60 basis points as a percent of sale higher than every other country in the world and so just by doing more elsewhere that'll help that number a little bit, same thing with labor costs.

We pay similarly great labor wages relative to whatever in-country norms are, but certainly the numbers in the US and Canada are higher than some of the countries. And so those things will help us a little bit.

Now I don't think -- there's nothing huge going on out there that -- I don't think we have any big shocks to the system.

Scot Ciccarelli

Got you. Thanks a lot, guys.

Richard Galanti

Thank you, guys. We will be around. Have a good day