Costco Wholesale Corporation (NASDAQ:COST) Q4 2012 Earnings Call
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Executives

Richard A. Galanti – CFO, EVP and Director

Bob Nelson – VP of Financial Planning & Investor Relations

Analysts

John Heinbockel – Guggenheim Securities, LLC

Charles X. Grom – Deutsche Bank AG

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Michael Montani – ISI Group

Peter S. Benedict (Justin) – Robert W. Baird & Co.

Operator

Good morning, my name is Tabitha and I'll be your conference operator today. At this time, I'd like to welcome everyone to the fourth quarter and fiscal year-end operating results for 2012 conference call. (Operator Instructions).

Thank you, Mr. Galanti, you may begin your conference.

Richard A. Galanti – CFO, EVP and Director

Thank you, Tabitha, and good morning to everyone. This morning's report as it relates to our 17-week fourth quarter and 53-week fiscal year 2012 operating results, both which ended September 2nd. For comparison purposes, the fiscal quarter and year are compared to last year's 16-week and 52-week periods for the prior fiscal year '11.

As with every conference call, I'll start by stating that these discussions we are having will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. And that these statements involve risks and uncertainties that may cause actual events resulting in our performance to differ materially from those indicated by such statements. The risks and uncertainties include but are not limited to those outlined in today's call as well as other risks identified from time to time in the company's public statements and reports filed with SEC.

For the fourth quarter, to begin with, our 17-week fourth quarter of fiscal 2012 operating results. We reported earnings of per share, of course, this morning of $1.39, up 29% from last year's reported fourth quarter earnings of $1.08.

Sales for the quarter were up 14%, which of course, include the extra week in Q4 of this year. We ended at 17 weeks this year versus 16 weeks last year. Now comparable sales, which we do compare like 17-week periods both years, were up 5% on a reported basis and up 6% excluding gas and FX.

Last year's fourth quarter results included a $32 million pre-tax LIFO charge that impacted last year's earnings per share by $0.04. This year's fourth quarter results included a $11.5 million pre-tax LIFO charge impacting this year's fourth quarter earnings by $0.02 a share.

Now several other items impacting the year-over-year fourth quarter comparisons of earnings include the following. First, the U.S. and Canada membership fee increased that took effect earlier this fiscal year. This added approximately $26 million pre-tax or $0.04 a share in this year's fourth quarter.

Second, FX headwinds, earnings from our foreign operations are converted into U.S. dollars when we consolidate and report our results. Year-over-year in the fourth quarter on average, the foreign currencies where we operate weakened versus the U.S. dollar. This resulted in roughly a $20 million pre-tax or $0.03 a share after-tax hit or impact to this year's fourth quarter. That is assuming FX exchange rates were flat year over year, our foreign country operating results in the fourth quarter when reported in U.S. dollars would have been higher by that amount.

Third, our $900 million pay-down of 5.3% fixed rate debt this past March. This reduced our interest expense comparison to year-over-year Q4 by approximately $15 million pre-tax or $0.02 a share.

Fourth, as reported earlier on July 9th, we completed the acquisition of the remaining 50% ownership interest in our Costco Mexico operations. The impact to our fourth quarter 2012 P&L was twofold. First, about a $0.02 per share benefit to fourth quarter '12 for the extra earnings we now own if you will. And second, a one-time charge of $8.3 million or $0.02 a share to our income tax line. This related to the dividend payment from Costco Mexico to Costco U.S.

For the purposes of the year-over-year comparison in the fourth quarter, these two items, relating to the Costco Mexico purchase, were essentially a wash to earnings. The earning accretion from our Costco Mexico acquisition will continue through the first anniversary of the transaction or next July.

And finally, a fifth item of comparison, we had an extra week, of course, this year in the fourth quarter, 17 weeks versus last year's 16 weeks. Simply dividing our fourth quarter earnings of $1.39 by 17 weeks, the positive impact to Q4 we estimate to be about $0.08 a share.

For the fiscal year, net income came in at $1.709 billion or $3.89 a share. This compared to $1.46 billion or $3.30 a share in last year fiscal '11. This net earnings were up 17% in dollars and up 18% on an earnings-per-share basis.

For the entire 2012 fiscal year, our LIFO charge was $20.5 million pre-tax or about a $0.03 hit to earnings. This compares to all of fiscal 2011 when it was an $87 million charge or $0.12 hit to last year's earnings.

Lastly on the FX front, the total negative impact to this year's sales was just under $600 million in the earnings hit, if you will, assuming flat year-over-year FX rates, would have been $31 million pre-tax or $0.04 a share.

Sales for the fourth quarter, again our 17-week quarter, as like weeks, was up 5% and this included the U.S. number of up 6% and international up 2%. Excluding gas deflation, there was an ever so slight deflation and a negative impact of FX and a sales increase – comp sales increase would be 6% for the total company as compared to the 5% reported. The U.S. would remain unchanged at 6%, again very little impact although as minor gas deflation. And international given the weakness in foreign currencies, international and local currencies, they reported 2% number when in instead it had been plus 7.

September sales results were reported last week on October 4th. Briefly, for the five-weeks September reporting period, U.S. comp sales came in at 6%, international at 7%, and total company at 6%. And again, excluding the positive impacts of gas and FX, U.S. comp sales on a normal basis if you will were up 5%, international up 6%, and total company up 5%. For September, the average ticket increased a little over 2% while frequency in air traffic increased by about 4%.

Other topics of interest, our opening activities and plans, we opened a total of 16 new warehouses during fiscal 2012. And again, that quarter ended on – that fiscal year ended on September 2nd. Of those 16, 10 were new in the U.S., 4 in Japan, and 1 each in Korea and Taiwan. In addition, we relocated one location during all of last fiscal year in Ontario, Canada.

For fiscal 2013, our expansion activities include a plan for approximately 27 to 30 new locations with just under half of those in the United States and the remaining in international markets.

During the first four months of fiscal '13, basically September through calendar year end here, we plan to open 14 new locations; almost the same number of new locations we opened in all of last year. Nine of these 14 will be in the U.S, three will be in Canada and one each will be in [inaudible] and Korea. I think most recently I mentioned that we estimated 15 locations; one in Wheaton, Maryland has been delayed due to construction issues and we estimate it now to open in March or April.

Also this morning, I'll go over our Costco Online results and some recent activities, our membership trends, additional discussions about our operating results for the quarter, and our stock repurchase activities.

Onto the discussion for quarterly results,. Very briefly, sales for the fourth quarter, again up 14%. Total sales at $31.5 billion this year in the fourth quarter versus $27.6 last year.

For the quarter, our 5% reported comps were a result of a combination of an average frequency or traffic increase of 4.5% and a flat average transaction year-over-year. I mentioned earlier that we all of a sudden started to see quite a bit of a weakness in foreign currencies. That flat average transaction includes that impact, a negative impact of about 1.5% from FX. So up a little assuming flat year-over-year FX rates.

Overall for all of fiscal '12, our average sales per warehouse for the 608 warehouses we have in operation, on an annualized basis was $154 million, up 7% from the $146 million figure in fiscal '11.

Moving onto sales by geography. For the fourth quarter, the strongest comp results in the U.S. were in the Northwest and the Midwest. All regions were fairly good and the range between the low and the high among regions was in 4% to 8% range.

Internationally, local currencies, Canada, Korea, and Mexico were the strongest and Japan at the weakest. Japan mostly due to cannibalization resulting from the four new locations opened this past year in Japan.

In terms of E-commerce, Costco.com and Costco.ca; sales were up 14% for the quarter and up 9% for the entire year. During the fourth quarter, as I think I mentioned, we're planning as of the last quarterly report, during the fourth quarter we launched Costco.com apps for both the Android and the Apple devices. And three weeks ago on September 16th, we transitioned Costco.com and Costco.ca sites to its new platform. The new platform certainly improves the visibility of the sites when using search engines and also we believe made several improvements to the sites from the end user perspective.

And lastly, next week we will open our new E-commerce site for the U.K., Costco.co.uk. We go live next Monday, October 15th.

In terms of merchandise categories for the quarter, Softlines was a standout for the quarter in the high single digits. Within Food and Sundries, comps were in the positive mid-single digits. Hardlines produced positive comps in the single digit range as well. Strongest sub-categories for the Hardlines were Hardware and Lawn and Garden, which were in the very high single digits. Consumer Electronics produced positive comps in the mid-single digits. Within the Softlines, the strongest numbers were in small electrics and domestics.

Lastly, all Fresh Foods comparable sales were up in the mid-to-high single digit range with the strongest results in Deli and Produce. And on the inflation front, Food and Sundries along with Fresh Foods continued to experience inflation in that low single digit range.

Moving down the line items in the Income Statement, we'll start with Membership Fees. In the fourth quarter, membership fee income was $694 million or 2.21%. This is up 18% in dollars and up 7 basis points. And it represents an increase of $104 million year-over-year in the fourth quarter.

In terms of Membership, we continue to benefit from strong renewal rates rounding up to 90% and U.S. and Canada and worldwide, 86%. We continue to experience increasing penetration of the executive membership. Incremental membership from the fee increase effective last November in the U.S. and Canada benefited the quarter by an estimated $26 million. The benefits from this will continue to show year-over-year increases throughout the four fiscal quarters of fiscal 2013 and into the first quarter of fiscal 2014. That, of course, is based on the fact that we used deferred accounting to book those increases.

Our new membership sign-ups in the fourth quarter were up 2% year-over-year. Last year in the fourth quarter, we opened 12 new locations including 4 in Asia and 2 in Australia. Those tend to have outsized new member signups as of through opening day. And that compares to six new openings this year in the fourth quarter, which included two in Asia.

In terms of the number of members at fourth quarter end, in terms of Gold Star, 26.7 million, up from 26.4 million at the end of the third quarter. Primary business, 6.4 million both at the end of the third quarter end, fiscal year end. Add-on business, 3.8 million at year end. That's up a little bit from 3.6 million at third quarter end. So total households, 36.9 million at year end, up from 36.4 million 17 weeks earlier. And with add-on with spouse cards, 67.4 million cardholders out there from 66.5 million a quarter ago.

At the end of the fourth quarter, we had 12.6 million executive members, which is an increase of about 245,000 or 2% since third quarter end and that's about 14,000 new executive members per week. Executive members, as I mentioned, represented little over a third of our member base and a little over two-thirds of our sales.

In terms of renewal rates, as I mentioned earlier, they continue to be strong. Business membership renewal rates ended the year at 93.7%. That's up a tick from 93.6% at the third quarter end. Gold Star, 88.7% at year end, up a tick from 88.6% at the end of the third quarter. So total U.S. and Canada, 89.7%, up a tick from 89.6%. And again as I mentioned, worldwide 86.4%, up from 86.2% at the end of the third quarter.

Based on our increasing U.S. and Canada renewal rates, we believe that the last November's renewal membership fee increase had little or no impact on our renewal rates, which continued to move higher.

In terms of gross margin, our reported gross margin in the fourth quarter was lower year-over-year by three basis points, coming in at 10.51% of sales this year in the fourth quarter, down from 10.54% a year earlier. I'll ask you to jot down a few numbers. I will have six columns basically looking at the fourth quarter and the prior two quarters. And each of those quarters will have two columns, both reported and without gas impacts, meaning inflation in Q's two and three and a minor amount of deflation in Q4.

Line items would be Core Merchandising, Ancillary Businesses, 2% Reward, LIFO, and Total. So going across the Core Merchandise in Q2, reported minus-25 basis points year-over-year and without gas inflation, minus 16. Q3, minus 21 reported and minus 14. And Q4 minus 10 and minus -10 and basically, the Q4 columns will be the same in both columns because again, while there was minor deflation, it was minor. It didn’t even change the basis point variances.

Ancillary, minus 2 reported and plus 2 without gas – I'm sorry, let me correct that one. For the second quarter, Ancillary was minus 5 and minus 4without gas. For the third quarter, Ancillary was plus 7 and plus 8. And for the fourth quarter plus 1 and plus 1.

2% Reward, minus 2 and minus 3 in the second quarter. Minus 2 and minus 3 again in the third quarter. And minus 2 and minus 2 in the fourth quarter. LIFO, plus 2 and plus 2 in the second quarter, plus 21 and plus 21 in the third quarter. Recall that last year the third quarter we had the first sizeable amount of LIFO. And in the fourth quarter, plus 8 and plus 8.

And then Total, in the second quart of ’12 we reported gross margins down year over year of 30 basis points but without gas inflation it was minus 21.

In the third quarter, we reported up 5 basis points total margin. Without gas inflation it would have been up 12. And in the fourth quarter, both reported and without that minor amount of gas deflation, minus 3 basis points.

Now, I'll focus my attention on the without gas column. Note again that in Q4 the gas really didn't have an effect anyway. As you can see from these overall numbers, the Core Merchandising gross margin in the fourth quarter was 10 basis points lower year over year. Actually, a small relative improvement from the minus 14 in Q3 and the minus 16 in Q2 on the year-over-year comparison. Ancillary business gross margins contributed a small amount up 1 basis point. Unlike prior quarters where our gas business, and again, as inflationary price trends have impacted the gross margin matrix, it didn't really do a whole lot here in the fourth quarter.

And the Core Merchandising categories, Food and Sundries along with Fresh Foods were slightly higher while Non-Foods categories, Hardlines and Softlines margins were a bit lower. The 2% Reward feature of our executive membership was incrementally higher or negatively impacted gross margin by 2 basis points as I mentioned. And again, LIFO, while we did have a charge of $11.5 million this year, that compared to a $32 million charge in the fourth quarter last year so that represented an 8-basis point improvement to our reported margin year over year.

We believe our margins are fine. Our inventories are clean. We had a great fiscal year end fiscal inventory result. In all, as you heard from us in the past, we remain committed to driving topline sales as we enter the Christmas holiday season and into calendar 2013.

Moving onto SG&A, our SG&A percentage in the fourth quarter year over year were lower or better by 18 basis points coming in at 9.6% of sales for Q4 compared to 9.84% in last year's Q4. Again, if you would jot down just a few numbers. The same three columns, the same six columns for second and third and fourth quarters. Operations, Core operations at Central, Equity, RSUs, and Total.

So again, going across, for Core Operations in the second quarter we reported an improvement or plus 25 basis points. Plus means lower SG&A.

Without gas inflation, it was plus 18. In the third quarter, plus 10 and plus 4. And in the fourth quarter plus 12 and plus 13.

Central, in the second quarter, plus 5 and plus 4. In the third quarter, minus 8 and minus 9. And in the fourth quarter, plus 6 and plus 6.

RSUs, minus 1 and minus 1. In the second quarter 0 and 0 and both in the third quarter and 0 and 0 in the fourth quarter.

And then Total, for the second quarter year over year reported SG&A lower or plus 29 basis point, without gas plus 21. In the third quarter, plus 2 and minus 5. And in the fourth quarter, plus 18 and there has been a rounding to plus 19. So again, that's the matrix that I'll talk about.

In terms of an editorial here, again, Operations were lower or better by 12 basis points year over year as reported, excluding the negative impact of very slight deflation in gasoline, the Core was actually better by 13. Within Core Operations, our payroll as a percentage of sales improved year over year in the fourth quarter by 6 basis points with a 2-basis-point offset to the healthcare cost lines.

Our Central Expenses were better year over year, or lower by 6 basis points. This is notwithstanding higher year-over-year IT costs related to our IT modernization efforts of our systems that we have embarked on. So overall, a continued focus, I think, on expense reduction or expense improvement and we think that was evident in the fourth quarter.

On the income – I will make one other comment. On the income statement, in terms of formatting, you may note or you probably haven't noted yet, that we have combined our former income statement line item provision for repaired assets and closing costs within SG&A because of it's an immaterial amount. I will mention that in the fourth quarter of '11 we had a charge of $2 million in the quarter on that line so that's added SG&A and in Q4 '12, that we had a minor charge of a few hundred thousand dollars. So both minor and historically very minor and will reclassify accordingly.

In terms of factors that will impact SG&A in ’13, the main items will continue to be sales trends, healthcare costs and gasoline sales and inflation in terms of percentages and increasing penetration of certain international operations, which have overall – which generally have lower overall SG&A percentages.

In terms of the next line item, Pre-Opening expenses, Pre-Opening expenses were $22 million last year in the quarter as compared to $15 million this year. So $7 million lower or 3 basis points better. Note, as I mentioned earlier, last year we had 12 openings in the quarter compared to 6 this year. All totaled operating income in the fourth quarter as up just under 25% year over year from $762 million last year in the quarter to $9 million this year, an increase of $187 million. Again, this includes the benefit of the extra week and the other items mentioned earlier.

In terms of interest and other, below the operating income line, we reported interest expense was lower year over year by $14 million with Q4 ’12 coming in at $22 million versus 36 million in last year’s fourth quarter. These amounts, again, may reflect the interest expense on the – no the previously $2 billion offering of [inaudible] of ’07, $900 million of that, of course, on March, this past March 15th was paid off. And again, the anticipated pre-tax interest savings given that we’re essentially paying off 5-plus percent in debt and [inaudible] on cash that’s earing sub-50 basis points ,that’s around $46 million pre-tax a year. For the fourth quarter this represented a reduction in interest expense of 15 million and again, on an annual basis about $46 million.

In terms of interest income and other it was lower year over year by 8 million, coming in at 38 million this year in the quarter versus 46 million last year. It was lower year over year largely due to the income last year in the fourth quarter related to gains on non-functional currencies held by certain of our foreign operations. Primarily this represented the U.S. dollars that were being held in Costco Mexico, which of course in Mexico, they’re a non-functional currency.

Historically, we'd always – we and our partner had always kept a portion of our cash expressed in dollars and again, we benefited from that even though we [inaudible] peso during this period of time.

Overall, reported pre-tax income is up 25% from $772 million last year to $965 million this year. Tax rate, our company's reported tax rate this quarter came at a 35.6%. This is about 30 basis points higher than last year's fourth quarter rate of 35.3. The income tax recorded due to the Costco Mexico dividend or the $8.3 million amount accounted for about 85 basis points of our fourth quarter 2012 tax rate and this was offset by year-over-year – well, this was offset year-over-year by increasing earnings attributed to our foreign operations, again, which generally had a lower rate.

Now for a quick rundown of a few other items. The balance sheet was included in the press release this morning. Some of you have asked me for the depreciation and amortization in the fourth quarter. For the quarter, it was $292 million which then for the year was $908 million. We always look at our accounts payable ratios. On the balance sheet it shows an improvement from 99% APS as percent of inventory last year to 103%. A big chunk of that difference there would be the payables on non-merchandise payables given all the construction activates we have going on.

So if we take out that and look at just merchandising payables and merchandising inventories, it was about the same year over year, 91% last year and 90% this year at quarter end. Average inventory per warehouse was up $458,000 or about 4% from last year's – our fourth quarter end our average inventory per warehouse was $11.2 million and this year, $11.67 million.

Electronics was about half of that, a little over half of that, $240,000 as we've been experiencing improving sales in that department. As you know, we continue to focus on the bigger-ticket items, you know, selling lots of things like 60 and 80-inch TVs. The remaining balance of variance is spread over many departments. Again, good inventory showing [inaudible] and good fiscal yearend inventory results.

In terms of CapEx, the fourth quarter, we spent $580 million and for all of 2012 just a shade under $1.5 billion. In fiscal ’13, our CapEx is actually [inaudible] quite a bit given the increase level of new openings as well as investments in operations and infrastructure such as depots in both Japan and Taiwan along with increased investment in IT related to our systems modernization projects that I had mentioned earlier.

Our current estimate for CapEx in fiscal 2013 compared – as compared to the 1.5 billion last year is somewhere in the range of 1.8 to $2 billion. In terms of our dividend earlier in May, we increased our quarterly dividend 14.5% from $0.24 per share or $0.96 per share on an annual basis, to $0.275 per share per quarter or $1.10 a share annualized. This dividend – this annualized dividend now represents a total cost to the company of just about $488 million.

And in terms of expansion, quarter we expect to open 9 warehouses in the first quarter, which is late November and an additional 6 in the second quarter, most of which is before – all but one which I believe is before calendar year end. In the third quarter, which stretches from roughly mid-February to roughly mid-May 7, and fourth quarter, the 16 weeks from roughly mid-May to the end of August 8. That would bring us to 30 for the year. That’s the budget, as I mentioned earlier. We’re talking about 27 to 30 and inevitably there’s always a few that fall out, but I’m happy to report that we have a lot going on between now and calendar year end.

Assuming we added 30 on a base of 608, that would be about a 5% square footage growth, which would certainly be our largest square footage expansion in years. Also as a fiscal year end, our total square footage was 86 million ,937,000 square feet. In terms of our stock repurchases, for the year we purchased 7.3 million shares at an average price of $84.75 bringing total expenditures over the last several years – over the entire fiscal year to

617 million, which I believe is about the same as – roughly the same, within 10 or $20 million of the amount we spent in 2011.

With that, as always, we'll have a supplemental information packet and that will posted on the Costco Investor Relations site later this morning. And with that, I'll turn it back over to Tabitha for Q&A. Thank you.

Question-and-Answer Session

Operator

(Operator instructions).

Operator

At this time if you'd like to ask a question please press star 1 on your telephone keypad. Again that is star 1.

Your first question comes from the line of John Heinbocket – Guggenheim Securities, LLC.

John Heinbocket – Guggenheim Securities, LLC

Hi Richard, it's actually Steve who is on for John today.

Richard A. Galanti – CFO, EV and Director

Hi.

John Heinbocket – Guggenheim Securities, LLC

Regarding inflation, when do you expect to see vendor price increases, and what magnitude are the company's buyers talking about?

Richard A. Galanti – CFO, EV and Director

Well this is very general, I mean, probably the standout area are things like protein. You know, pork, beef, and poultry. And the anticipation is over the next several months given some of the issues with wheat and corn, that that will continue to go up. Some of the bakery raw materials for the same reasons will go up, and they're still talking in the mid-field digit or a little higher range, but that's the guess at this point. I don't hear a lot on the other areas. In fact in just our first month if you will of this fiscal year in September, we saw essentially company wide, as reflected through the LIFO calculation of almost exactly flat. I mean one basis point of inflation. And there was a little bit, you know again, well less than half a percentage point in the Food and Sundries categories and a little bit of deflation in things like apparel and electronics. And again, the apparel has more to do, I think, with – some of those prices are down from a year ago when they were quite high, and still higher than a few years ago. So, if you add it all up, modest inflation is the expectation with it being geared more towards some of the fresh food items, and raw material food ingredients.

John Heinbocket – Guggenheim Securities, LLC

I guess about handling you past through, do you guys expect to pass everything through, or? I think you said the margin on Food and Sundries was up for the quarter, right?

Richard A. Galanti – CFO, EV and Director

Yes. Look sometimes we do and sometimes we don't. Generally speaking things like, you know, refrigerated fresh food, you know meat, and things like that, those prices change daily and weekly and the input costs change daily and weekly, in some cases, and the sales prices. We like everyone in the fresh food business are price checking out competition and adjusting accordingly. As you know from history, that there are times when we're not going to change the cold of a sixteen pack of muffins or the cost of a slice of pizza when cheese went up, but generally speaking there's not those out-sized areas.

Now that being said, also things like fresh meat are very competitive, and you know we're out there where we can gain a little strength in that area, as the higher end cuts of beef and some of the organic aspects of beef where we can show a greater savings and make a little better margin. But those are still small percentages of the total sales.

John Heinbocket – Guggenheim Securities, LLC

Okay, and then just looking at expansion of the longer term, obviously 27 to 30, as you said is the largest you guys have done. But what would you say the principle bottleneck, when it comes to club expansion, when you get to that high upper 20s range, and what would you say is your maximum amount of clubs to add within a year, that you can execute at a high level?

Richard A. Galanti – CFO, EV and Director

Well, I mean, as you know been hands on, and I'm guessing operationally that the clubs we do we can easily handle 30, the challenges operationally. The bottleneck really has been ourselves in terms of,

One: It takes a little longer to find and develop sites in some of these foreign countries like Asia, and subject to other appeal processes. There's some countries where the competitors can appeal you just to appeal you and slow you down, which isn't very nice. But at the end of the day, you know, I think we've got a lot more in the pipeline finally. We have more people devoted to real estate, we have on the ground physically in I believe every country over the last couple of years, and so again, the pipeline is more filled and I think that's evidenced in the amount that we are doing some of these countries where it does take longer like some of the Asian countries, Australia and the like. So, I think the bigger bottleneck was us, and it's finally picking up a little bit.

John Heinbocket – Guggenheim Securities, LLC

All right, thanks.

Operator

Your next question comes from the line of Charles Grom – Deutsche Bank. Charles, your line is open. If you have placed your line on meet, please then meet. Hello? Yes your line is open, please go ahead. Okay there question has been withdrawn. Your neck question comes from the line of Chuck Cerankosky – North Coast Research.

Charles E. Cerankosky – North Coast Research

How's it going Richard?

Richard A. Galanti – CFO, EV and Director

Hi.

Charles E. Cerankosky – North Coast Research

I want to go through a couple of things with you to start with on the fuel. Could you talk about how profitable fuel was in the quarter and what the comp-gallons groups were?

Richard A. Galanti – CFO, EV and Director

Well I think, first the profitability we never talked about how profitable it is. We talked about how it is year-over-year when there's outsize changes to it, because it can fluctuate quite a bit. Actually on a quarter-over-quarter basis, year-over-year it was pretty, less than a penny I think of difference, so really nothing to speak of there. As you know when prices are going down, profits are up and there was some of that both this fiscal quarter, as well as in the fourth quarter of last year, so both quarters had some pretty good profits year-over-year.

And in terms of Chuck the other question was?

Charles E. Cerankosky – North Coast Research

Fuel comparable gallons?

Richard A. Galanti – CFO, EV and Director

Yes the comp-gallons in the fourth quarter are 6%, and that compares to 8% in Q3, and quite a bit more in September for whatever reasons. I guess because prices were going back up. That's it.

Charles E. Cerankosky – North Coast Research

Excuse me, at the end of the fiscal year what was your square footage.

Richard A. Galanti – CFO, EV and Director

Let's see here, it was 86,937. [inaudible]

Charles E. Cerankosky – North Coast Research

When you are looking at the nice performance you had Richard in the fourth quarter, what elements of the gross profit margin and the SG&A, especially the SG&A improvement do you think are sustainable into the new year?

Richard A. Galanti – CFO, EV and Director

Well I think the easiest sustainable things for the next few quarters are those things that we've done like the debt pay down, the Mexior acquisition, and the membership fee increase and how that affects the [inaudible]. So all those things, you know they're permanent for a year, they continue for a year and then it's part of the base.

Beyond that, I mean, I think that the sales drive – you know, you've always heard from us that were a topline company, certainly our relative sales strength has helped us here. I think the focus on little things – I've thrown out some examples over the last months and quarters about the past year one of the [inaudible] items is overtime hours, and I think we showed for the first 40 or so weeks of the fiscal year at one of our budget meetings that aggregate hours were up 3 ½ or so percent year for the year. Overtime hours were down 25%. You know, not a lot of money maybe 10-15 million dollars a year, but it's real. And maybe it goes over – maybe you don't get it all in the first year, you get over a couple of years. But those are the kinds of things that we see out there. Is that sustainable? I mean what’s sustainable is our efforts to do it.

I think on the margin side, as I’ve said in the past, it’s more us than them, whoever them is, when we’re competing with them. We tend to be proactive in it, we’ve been asked about the question now that some of the quote [inaudible] price is starting (the anniversary) from when it was being discussed a year ago. Does that mean it’s over, or there’s more of it, again we don’t talk about that. I can assure you that when things are good we’re going to continue to do things to drive the business.

Charles E. Cerankosky – North Coast Research

All right thanks. A couple of more things Richard, do you a full year fuel sales figure that you can give us at this time, and can you comment on what the spike in retail gasoline prices in California on the fuel prices there, what’s that doing to traffic and gasoline sales?

Richard A. Galanti – CFO, EV and Director

I don’t have anything specific on the total dollars. I think for the year it was like 12 or so percent of sales. The craziness in California had to do with all the moons lined up bad, and there was several days there of incredible supply shortage. As you would expect we are a major consumer in the greater L/A market, we have close to 40 locations, and at the peak or at the trough I guess we had 16 or so of those stations closed for one or two days. Happily that ended, I believe this Sunday and we’re back to normal generally. The impact to us was, again it did get people – my sense was, what I heard was is that it was a little bit of the concern that there’s gas shortage everywhere and people were topping off their tanks, so it created more volume. We saw a little bump in sales at those locations in store. But we were also in some cases losing money at the gas pump. So my guess is it wasn’t a big impact to us, and to bottom line we lose money no doubt in gas and made money with extra cars in the parking lot coming to get gas. It’s really a blip for a few days in California, Southern California.

Charles E. Cerankosky – North Coast Research

Thank you very much.

Operator

Your next question comes from the line of Deborah Weinswig (Nathan Rich) – Citi.

Deborah Weinswig (Nathan Rich) – Citi

Hi Richard, this is Nathan Rich filling in for Deb today. I wanted to go back to the decision that you guys made to accelerate club growth. I was just wondering if you could provide a little bit more detail on where the international expansion is going to come, in terms of what markets are focused on, and also are there any new markets internationally?

Richard A. Galanti – CFO, EV and Director

Well the markets – in Canada we opened a couple of three a year, maybe sometimes one, maybe three, but probably two to three on average. In Mexico we'll probably speed it up a little. Over the last five years I think we've opened two locations, so 0.4 locations a year historically over the last five years. You know it's going to take a little time here, but you know, I would expect that to grow at least two or three years starting after this year. We have one or two in the U.K. this year after a few years of no growth. But the big expansion for us continues to be in the three Asian countries where we're at, Korea, Taiwan, and Japan, and Australia. Now all those countries take a little longer because of the complexity, these are building up not out, you know multi-floors and it takes a little longer. But again, we had the pipeline full.

The only other things we talked about is Europe and I can't – we are pursuing in a couple of Western European countries, and if all goes well maybe five years from now we'll have a few locations opened in each, but I cannot tell you whether it's going to be, you know twelve months or thirty months before we have our first opening in any country over there.

Deborah Weinswig (Nathan Rich) – Citi

Great, and then also if I could a question. It seems like you saw some improvement in food margins, both Food and Sundries and fresh foods. Those have been trending flat to down over the past several quarters. I was just wondering what caused the change in trend this quarter?

Richard A. Galanti – CFO, EV and Director

You know without looking deep into it, my guess is some of it has to do with the fact that it was a year ago when we were explaining there was some anecdotal comments I made probably about the fact that we maintained pricing on some highly inflationary cost items like: The food court with cheese pizza, like the bakery. So part of that I think is just the cycling of perhaps some unusual things the other way. I think a little of it, not a lot of it, but a little of it, has to do with increasing penetration in some fresh foods with the KS, the Kirkland Signature name. Some of it has to do with the comment I mentioned earlier about organic. These are small things, but there's more and more of them. If we can take 20 or 30 million dollars out of a few hundred million dollars a year of ground beef sales from a highly competitive basic ground beef line, and put it into organic, that's good for us because we can sell it, because we have that kind of member. It's good for us because that member sees – let's just say a higher price point item, but the member sees an even greater relative value because those are the items that are as competitive out there. So we can provide the customer more and do more. So all those things I think add up.

Deborah Weinswig (Nathan Rich) – Citi

Okay great. Then just lastly if I could, I'm interested to hear what you're seeing in terms of early selling for fall and holiday, and if you could comment on TVs in particular, which I think have been pretty good for you recently?

Richard A. Galanti – CFO, EV and Director

On the latter, the TVs have been strong the last couple of months that we reported. In large part I think because we focused on the higher end, or the bigger ticket size. And we have a lot of TV strength if you will, in the 60 to 80-inch TV, so the bigger we do – we do a little better on those.

On seasonal, again it's still early, so far so good. I don't think there's been anything outlandish, plus or minus in hearing from the buyers in the last month or budget meetings.

We'll have a little more collar at the end of October, which is really the more meaningful month.

Deborah Weinswig (Nathan Rich) – Citi

Great, thanks so much and best of luck.

Operator

Your next question comes from Michael Montani – ISI Group.

Michael Montani – ISI Group

Hi, Richard. I was just going to ask you, on the inflation side, you know, you mentioned sort of a low-single digit increase this quarter for Food and Sundries. If you looked across the box, you know, can you just give us a feel for that? Are we talking 1 to 2% range across the store right now?

Richard A. Galanti – CFO, EVP and Director

Well, low tenth of a single digit. It's closer to 1, so not a whole lot.

Michael Montani – ISI Group

And that's across the store?

Richard A. Galanti – CFO, EVP and Director

It’s all over the board. I mean, I was looking just at some items, I mean, these are, you know, again, these are anecdotal items, but you know, year over year eggs are up 22%. I’m looking down the list here. Blueberries up 37% year over year. Conversely, you’ve got items, always you’re going to have some electronic items, but beyond electronic items, I can’t tell you why, back is down 17%. Gasoline down a couple of percent. So it’s all over the board, but overall, when you think of a whole basket of things, up very little for the month.

Michael Montani – ISI Group

And then just thinking about moving forward if you could see any single-digit type inflation on the food side, again, does that translate across the store to something, again, that’s maybe a couple 100 bits less than that just given the other categories?

Richard A. Galanti – CFO, EVP and Director

Not necessarily. First of all, there’s no – when we talk about mid-single digit inflation, I was really talking about things like your expectations that our buyers have for things like meat and poultry and pork, which again, are more in the extreme inflation categories in terms of talking amongst the buyers. Again, Food overall is by no means that level and then, of course, as I mentioned, there’s a few things that are ever so slightly deflation right now like apparel and electronics.

So really there’s no – and I guess the inflation is going to be very, very low single digits this year as we know of today. Life could change tomorrow.

Michael Montani – ISI Group

And then just maybe for a minute on the competitive set, are you seeing anything that’s noteworthy versus this time last year in terms of how your club competitors are pricing or traditional grocers out there?

Richard A. Galanti – CFO, EVP and Director

Not really.

Michael Montani – ISI Group

Okay. Just one housekeeping thing is on the FX impact for membership income, I was getting to around the $7 million impact roughly. Does that makes sense to you?

Richard A. Galanti – CFO, EVP and Director

I think – hold on a second. I think that's close.

Unidentified Male

That's correct.

Richard A. Galanti – CFO, EVP and Director

$8 million.

Michael Montani – ISI Group

$8 million, okay, great. And then just lastly with the new store openings accelerating and trying to go a bit more international in terms of the mix there, is it possible, Richard, to give us just an understanding a little bit of the pre-opening expense for International versus the U.S. origin and also on the CapEx side, given the step up, is there a way to bucketize that in terms of X amount goes towards IT versus new stores?

Richard A. Galanti – CFO, EVP and Director

You know, it has more to do – International, generally, is more and you know, it could be – and these are, you know, if you were [inaudible], there's other things put into openings too, like when we add a gas station or we open a depot or a – all those kinds of things. So you know, generally speaking, now remember, this goes back several years, but it used to be like a U.S. warehouse was a million, plus or minus a little and an International, I say International outside of North America might has been as much as 1.5 million or 1.75, but those are guesses. Yes, it's more in some of those countries but you know, a big chunk of pre-opening is not just the – you can't just take the pre-opening divided by the number of warehouses and that's the average for the warehouse because you have a lot of other pre-openings. Every time we add a gas station, that's' going to – it's a new operation. You know, we've done it consistently from day one, but there's a lot of other things in there as well.

Michael Montani – ISI Group

And just on the CapEx side of the ball, Richard?

Richard A. Galanti – CFO, EVP and Director

What's that?

Michael Montani – ISI Group

On the CapEx side as well in terms of the cost for warehouse, domestic versus International?

Richard A. Galanti – CFO, EVP and Director

It's probably 20 to 30% more on average, sometimes – there will be some wide ranges. I mean, I think we say in the U.S. generally that land, building and site we own is somewhere in the low-to-mid 30s. My guess is overseas it could be in the low-40s on average, but it could range from mid-30s to high-50s, all over the board. But you know, as you know, some of those higher numbers, we can get a better return on investment.

Michael Montani – ISI Group

And maybe just the last thing if I could ask it is, Affordable Care Act and what you all are hearing right now in doing the prepare for that. Is there anything you can share in terms of the percentage for your employees that would be covered today or the percentage of the coverage that you all provide or anything that would be helpful?

Richard A. Galanti – CFO, EVP and Director

I think we provide as much if not more than anybody else I know in our space, in general retail. All of our employees, both part time and full time are covered. It takes three to six months currently, depending on if you're part time or full time. Each year for the last two or three years and certainly this year and next year under different parts of the new Healthcare requirements, there's been some additional input numbers into our expense. You know, one year it's covering people to 26 years old. One year it's mental health. One year it's – I forget the other ones off the top of my head. But at the end of the day, each of these things need to have added an incremental 1 or 1.5% to our already outsized number.

So we don't think it's going to have a big impact to us like it may to others but you know, others may do some things that may be less of an impact to them. I don't know, but it's fair to say from our perspective, it's kind of been built into our numbers and we've been able to handle it.

Michael Montani – ISI Group

Great. That's very helpful. Thank you and good luck.

Richard A. Galanti – CFO, EVP and Director

Thank you.

Operator

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

Peter S. Benedict (Justin) – Robert W. Baird & Co.

Hey, Richard. It’s actually Justin for Pete. Just a question on the membership fee income. Can you help us understand how much that line item benefited for the extra week?

Richard A. Galanti – CFO, EVP and Director

I think the simplest way to do it, and this is not exact, but I first take this number this year and subtract the 26 from it because we know the 26 is the [inaudible] accounting for the free increases. And from that number, I’d say, okay, this is 17 – I’m very sorry, divided by 17 and I’d subtract that amount from that number and then I compare the two. The adjusted number, and I think what you get is something in the 6 or 7% increase change in dollars.

Peter S. Benedict (Justin) – Robert W. Baird & Co.

Okay, that’s helpful. Thanks. And then the $26 million of incremental MFI from the fee increase that you cited here in the fourth quarter, did that absolute dollar number – should we expect that to build over the next few quarters?

Richard A. Galanti – CFO, EVP and Director

Yes. And It will build – well, it will build a little bit into Q1, recognizing Q1 is a 12-week quarter versus a 17-week quarter, so the absolute dollars will be a little low. It will build quite a little bit more in Q2. It will build – and then it will start going the other way, but still pretty sizable numbers in each of these four fiscal quarters. It’s $0.03 to $0.05 per quarter in each of these quarters.

Peter S. Benedict (Justin) – Robert W. Baird & Co.

Okay. Thanks. And just any color on as it relates to traffic conversion rates, average ticket size from the replatforming of the online business or is it just simply too early to tell with that?

Richard A. Galanti – CFO, EVP and Director

Yes, it's very simply too early. It's only been a week or so and the thing I'm most happy about is there weren't any big glitches and we got it converted in about an 8-hour period, closing the old site and opening the new one. So we'll see over time.

Peter S. Benedict (Justin) – Robert W. Baird & Co.

Great. Just lastly, a housekeeping question here. In that interest income and other line item, do you have what the interest component of that was?

Richard A. Galanti – CFO, EVP and Director

Sure. Hold on. Actual interest income was 14- almost $15 million last year and $16.3 this year. So up 1.3 million.

Peter S. Benedict (Justin) – Robert W. Baird & Co.

All right. Great. Thanks. Good luck over the holidays.

Richard A. Galanti – CFO, EVP and Director

Yep.

Peter S. Benedict (Justin) – Robert W. Baird & Co.

Thank you

Operator

(Operator instructions). Your next question comes from the line of Charles Grom with Deutsche Bank.

Charles X. Grom – Deutsche Bank AG

Thanks. Just on the – the new store growth going up to 25 to 30 clubs, should we expect that pace to continue to grow over the next few years? And it's been a while since I heard you guys talk about a longer-term club target, but you know, with growth in Europe, Australia, more growth in

Korea, Japan and Taiwan. Can you maybe refresh us in kind of where it your thoughts are?

Richard A. Galanti – CFO, EVP and Director

Well, you know, given our history over the last several years of under-opening locations. I think we feel very good about this coming year that, that very high 20s and you know, we're looking at numbers, we had a slide recently that showed over five years somewhere in the 125 to 150 locations, which we've implied 25 to 30 a year. Europe, again, if all goes well, maybe we'll have, you know, five years from now five or six in Europe or eight on the outside, but more likely five or six. That's if it continues to progress. There's still a few hurdles to get over there in terms of timing. We will be there is my sense but it will take some time. So I think, again, part of the, as I mentioned earlier, part of the – perhaps the reduced level of confidence that we've got – we've got a lot more irons in the fire and particularly in those countries where the lead time to get openings done, you've got to work on more projects to get more opened and even thought it takes longer, again, for the last year or two, we've had people on the ground in some of these countries where historically we didn't.

Charles X. Grom – Deutsche Bank AG

Okay, fair enough. And then when we look at the complexion of your margin structure here in the fourth quarter, you know, gross profit margins are down a little bit, but SG&A levered to produce some pretty nice operating margin expansion of about 19 basis points. When you take a step back and look at your kind of long-term earnings algorithm, is that sort of a good recipe for success for you guys? Is that the kind of structure you kind of want to build out?

Richard A. Galanti – CFO, EVP and Director

Well, you know, in the ideal world, as I think Ken said, 25 years ago, that we – some things – you know, we'd accelerate the membership fee, it would be a lot higher. We'd keep lowering expense percentages and we keep lowering prices. But you know, ideally, yes, we want to keep doing that because it makes us more competitive and keeps driving the business and puts a bigger wedge in between us and others. But we're also realistic. But yeah, that's – mission wise, that's fair.

Charles X. Grom – Deutsche Bank AG

Okay. And then my last question is, you know, I wasn't going to ask this on the call but you guys really continue to build up cash on the balance sheet and we get a lot of questions from investors about what you're going to do with it. And I realize, you know, buybacks are a steady pace for you guys but is there any thoughts from the Board to really step up the dividend? It's a lot lower than some of your peers despite having a much stronger cash and an overall balance sheet position.

Richard A. Galanti – CFO, EVP and Director

Well, I mean, you know, yield wise it is. You know, we continue to whatever, 13 or 14% a year. We always discuss it informally about what should we do, but there's not a great sense of pressure to change or MO at this point. Probably the biggest pressure point is to spend more money on CapEx. I'm glad to see the fact that it's a number that went from the range of 1.4ish in the last few years to approaching 2 this year. I think that you know, and 14, if we continue to spend like we are, maybe it's about the same as this current year's budget. If it's a little less it's only because of some of the unusual things we're doing this year like a couple of extra depots in some of these new counties. So but overall, you know, getting that number up 400, 500 million from where it's been, that helps.

Charles X. Grom – Deutsche Bank AG

Got you . And then, I'm sorry, I did hop on a couple minutes late, but could you just remind me what the quarter-on-quarter profit number margins was, this quarter and then if you go off through some of the categories within that outside of gas, I'd appreciate it. Thanks.

Richard A. Galanti – CFO, EVP and Director

Sure. In terms of margins, for the quarter, the quarter was down 10 basis points year over year and the – with our without gas is the same. There was minor gas deflation but not enough to affect the basis points. So clothes was down 10, ancillary was down 1, 2% was down [inaudible] about a 1% increase in sale translation of those numbers. LIFO was up 8 because of the lower charge this year versus last year. You add it all up and that's our reported as adjusted with gas minus 3.

Charles X. Grom – Deutsche Bank AG

And then within that core, the 10, any major differences between the other four major subcategories?

Richard A. Galanti – CFO, EVP and Director

Yeah, Food, Sundries and Fresh Foods were up a little. Hardlines and Softlines were down a little, a bit more than a little, but not a lot.

Charles X. Grom – Deutsche Bank AG

Okay, thank you.

Richard A. Galanti – CFO, EVP and Director

Thank you.

Operator

Thank you. That ends our conference call for today.