Costco Wholesale Corporation (NASDAQ:COST) Q3 2018 Earnings Conference Call May 31, 2018 5:00 PM ET

Executives

Richard Galanti - Chief Financial Officer

Analysts

Simeon Gutman - Morgan Stanley

Michael Lasser - UBS

Chuck Grom - Gordon Haskett

John Heinbockel - Guggenheim Securities

Karen Short - Barclays

Peter Benedict - Baird

Kate McShane - Citi

Dan Binder - Jefferies

Chuck Cerankosky - Northcoast Research

Laura Champine - Loop Capital

Kelly Bania - BMO Capital Markets

David Bellinger - Oppenheimer

Operator

Good afternoon. My name is Josh, 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] Thank you.

Mr. Richard Galanti, CFO. You may begin your conference.

Richard Galanti

Thank you, Josh, and good afternoon to everyone. I'll start of course by stating that these discussions 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, results and/or performance to differ materially from those indicated by such statements.

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

In today's press release, we reported our operating results for the third quarter of fiscal 2018, the 12 weeks that ended on May 13th. Net income for the quarter was $750 million or $1.70 per share that compared to $700 million or $1.59 per share last year in the third quarter. Last year in the third quarter, net income was positively impacted by the $82 million or plus $0.19 per share tax benefit and that was in connection with the $7 per share special cash dividend that we had done at that time.

I'll start by reviewing our third quarter operating results and then allow some time of course for Q&A. In terms of sales, net sales for the quarter came in at $31.62 billion, or 12.1% increase over last year's third quarter sales of $28.22 billion. Net sales for the first 36-weeks of fiscal 2018 increased 12.0% to 95.02 billion, up from $84.82 billion last year to date – last year for the first three quarters year-to-date.

In terms of comparable sales, which are reported in the press release, for the 12-week period U.S. was 9.7, excluding the impact of gas inflation it was 7.7. Canada on a reported basis for the 12 weeks comps were 11.3, and ex-gas inflation and FX impact was up 4.8. Other international reported at 11.8, ex-gas inflation and FX 5.8. So, all told, total company at 10.2% comp and ex-gas inflation and FX up 7.0%.

E-commerce, which we, of course separate out here is 36.8% for the 12-weeks, and 35.5% ex-FX. So that continues strong. Similar statistics in the press release for the 36-weeks year-to-date. In terms of third-quarter sales metrics, third-quarter traffic or shopping frequency was up 5.1% both worldwide and within the U.S., strengthening foreign currencies relative to U.S. dollar impacted sales by approximately 145 basis points to the positive, and gasoline inflation added an additional 170 basis points.

Cannibalization weighed on the comp to the tune of minus 60 basis points. Our average front-end transaction or front-end ticket was up 4.9%, and again excluding the benefits from both gas inflation and FX that average ticket would have been up somewhere in the mid-high single digits about 1.7%, 1.8%, up. Next on the income statement and membership fee income, reported in the quarter $737 million, up $93 million from $644 million during Q3 of last year or up 14.4%.

The benefit of strong foreign currencies was about 9 million of that $93 million increase or ex that it would have been $84 million. Now, of the $93 million increase year-over-year, a little over half related to the membership fee increases that we have taken in the last year, year-and-a-half. The majority of which came from the $5 and $10 annual fee increases taken last June 1 in the U.S. and Canada. And a small balance of that from the fee increases taken other international operations starting back in September of 2016.

We will continue by the way to see membership fees based on the deferred accounting, the June 1, 2017 increases in U.S. and Canada last year. We continue to see the benefit of that year-over-year increase in the membership fee line. It will peak in Q4, this coming quarter, this 16-week quarter and then still year-over-year increases, but all are – at least three may be four of them, all of next year in fiscal 2019 as well. In terms of membership fee renewal rates, our U.S. and Canada member renewal rates at Q3 end came in at – were 90.1%, similar to where they stood a quarter earlier at 90.1. Slight uptick just rounding to the 90.1.

Worldwide rates improved to 87.5%, up from 87.3% 12 weeks ago at Q2 end, with the uptick in renewal rates and other international operations led by Asia, both Taiwan, Japan and Korea. In terms of number of members at Q3 end, in terms of total number of households at the end of Q2 it stood at 50.4 million and 12 weeks later at the end of Q3 is now – it then stood at 50.9 million. Total cardholders, 92.2 million a quarter ago, 12 weeks ago, and at Q3-end 93.0 million.

During the fiscal quarter, we had two new openings. Also, at Q3-end, as of Q3-end our paid executive member base stood at 19.0 million households. That’s an increase of 199,000 households from 12 weeks earlier or about 17,000 new Gold Star members per week. Related to the benefit from last year's fee increases that year-over-year quarterly fee increase volumes I mentioned continue to benefit both Q4 and into several quarters next year, but on a diminished amount year-over-year quarter.

Going down to the gross margin line, our reported gross margin in the third quarter was lower year-over-year by 46 basis points, coming in at 11.05% during the third quarter of fiscal 2018 compared to 11.51%. Now that minus 46 basis point figure year-over-year on a reported basis, excluding gas inflation it was minus – it would have been minus 28 and let me again ask you as I usually do to jot down just a couple of columns for Q3 2018. The first one would be, as reported, and the second one would be excluding the impact of gas inflation. The five-line items, the first one would be merchandise core.

In Q3 2018, on a reported basis that was down year-over-year by 33 basis points and ex-gas inflation down by 17 basis points. Ancillary businesses reported minus 10 basis points year-over-year, minus 6 ex-gas inflation, 2%

reward plus 2 as reported and flat without gas inflation. Other minus 5 and minus 5, and I'll talk about that in a second. So, total if you add up those two columns, on a reported basis again, gross margin was lower by 46 basis points, ex-gas inflation lower by 28 basis points.

As I mentioned, looking at the core merchandise categories in relation to their own sales, so quarter-on-quarter if you will, margins year-over-year and in Q3 were lower actually by minus 4 basis points. Subcategories within core gross margin year-over-year in Q3. Food and sundries was up slightly and hardlines, soft lines, and fresh foods. The other three components of core were down just slightly. The slightly year-over-year core on core gross margins in third quarter resulted from our continuing investment in price to drive sales and widen the value gap between us and our competition.

Ancillary and other businesses gross margin, I think were reported down 10 – down 6 ex-gas. Some of that has increased gas sales penetration, which is a much lower margin business rather other parts of it is - some of the other ancillary businesses were down a little bit as well. 2% reward was flat ex-gas as I mentioned, and other, which was a minus 5 year-over-year comparison, 5 basis points.

Last year, we were incurring some incremental costs where we have been, as I mentioned last two quarters we've been incurring some incremental costs primarily related to the rollout of our new centralized returns facilities. This will continue to impact us for one more quarter in Q4. In each of the prior two quarters I had mentioned on a sequential basis on a year-over-year. In Q1, we estimate it was about 7 basis point negative impact, in Q2 minus 6, and in Q3 minus 5, and again there will be some small detriment I assume in Q4 and then we will have anniversaried that.

Moving to SG&A, our SG&A percentage in Q3 year-over-year was lower or better by 32 basis points on a reported basis and ex-gas inflation better or lower by 16 basis points, coming in at 9.98% of sales this year reported compared to 10.30 last year. Like with gross margin, I will ask you to take the two columns. First one is of reported Q3 2018, and the second column would be, excluding the impact of gas inflation for Q3 2018. First one, operations, better or plus 26 basis points on a reported basis and plus 13 basis points or lower in ex-gas.

Central, minus 1 and minus 3. Stock compensation plus 2 and plus 1. Other plus 5 and plus 5. So, if you add those two columns up. The first column would add up to the reported 32 basis point improvement in SG&A and again ex-gas inflation it would be plus 16 basis points. Basically, it’s all about sales. Core operations, lower better strong topline sales lead to improvement in payroll benefits and other variable fixed costs generally speaking. Central expense was higher year-over-year as you can see in the chart we just made by one basis point on a reported basis and three without gas, primarily related to our continuing IT efforts.

Stock compensation again lower by little against strong sales help that. Other, better by five. That really is nothing this year. Last year, we pointed out that there were two non-recurring legal items in Q3 last year totaling $14 million or 5 basis points. And we didn’t have any detriment related to that this year.

Next on the income statement is preopening. Preopening this year came in at $8 million lower by $7 million from last year's $15 million. This year in Q3, as I mentioned, we had two openings; one in Mexico, and one in Korea. Last year, we had three openings. One each in the U.S., Canada, and Mexico. Last year in the number we also had some additional spend in Q3 relating to the fourth quarter openings last year in France and Iceland.

Upcoming in Q4 this year we have 15 total openings, 13 net new units, plus 2 relocations. That compares to 12 gross and net locations last year in the quarter. All told, reporting operating income in Q3 came in at $1.67 billion or up $99 million or 10% higher than year-over-year than last year's 968. Below the operating income line, reported interest expense came in at $16 million higher year-over-year at $37 million this year that compares to $21 million a year ago. That’s mostly a result of last May's $3.8 billion debt offering debt offering that we did in conjunction with our special dividend.

Interest income and other was higher or better year-over-year by $23 million in the quarter. Actual interest income and mostly interest income for the quarter was better or higher by $6 million. We also benefited year-over-year comparison by various FX items to the tune of $17 million. That’s a number that fluctuates both ways, and generally speaking, it’s in the zero to $15 million range, but this one was plus 17.

Overall, pre-tax income was higher by 11% or $106 million in the quarter coming in at $1.71 billion compared to last year's $965 million. In terms of income taxes, our tax rate in the quarter third quarter this year came in at 28.8%, compared to last year's reported tax rate of 26.8. Now, last year of course on a normalized basis, I mentioned that we had that $82 million tax benefit related to the potential dividend. Last year's normalized rate was 35.3. For fiscal 2019, based on our current estimates, which of course are always subject to change, we anticipate our effective total company tax rate for the entire year with the change in U.S. tax rates benefiting the entire year.

The tax rate to be approximately 28%, as we will have the full fiscal year under the new U.S. Federal rates. Before I leave the subject of tax law changes, I'll make a couple of comments on that in terms of what our plans are viz-a-viz the savings. As I had mentioned last quarter end, we really don’t expect any major changes to our capital allocation plans. We generate good cash and pretty much do the things that we want to do, in terms of expansion and in terms of regular dividend and in terms stock buybacks as well.

As mentioned on last year's earnings call, I said we would use some of the income tax savings in the U.S. to benefit our U.S. employees and that there will be increases in the early wage rates. Effective June 11, our U.S. starting wages will increase from 13 and 13.50 an hour to 14 and 14.50 an hour. So,

$1 an hour for entry level. With all other hourly warehouse employees receiving hourly increase of anywhere from $0.25 to $0.50 per hour.

The estimated annualized cost of these increases will impact about 130,000 plus employees in the United States, will be $110 million to $120 million pre-tax, with Q4 being impacted by little more than $25 million pretax. We have been investing, second, next we have been investing and we will continue to invest some of the savings to drive our business. This will certainly include investing in price, as well as other activities. Some of the tax savings this way will fall in the bottom line indirectly by investing and driving value and sales. And then some of the tax savings will go straight to the bottom line.

A few other items of note, in terms of expansion, I mentioned we have 15 total openings scheduled for the upcoming 16-week fiscal fourth quarter, which include two re-lows. So, we will have 13 net openings. That would put as at 21 net new openings for the fiscal year. 25 total, less four re-lows. In Q1, we opened seven locations net of five. In Q2, we opened one. In Q3, as I mentioned, we opened two. And for all of fiscal 2018, again, the 21 net-new. Of those 21 net-new, little under two-thirds of them will be in the U.S.

Additionally, for fiscal 2018, we will relocate before, all of those in the U.S. and those were relocated to better and larger facilities. As of Q3-end, total warehouse square footage stood at $108 million square feet. In terms of stock buybacks in Q3, $54 million was expanded. So, Q3 year-to-date for the 36 weeks we repurchased $233 million worth of stock or 1.337 million shares at an average price of 174.30 per share.

In terms of our e-commerce activities. E-commerce, we currently operate e-commerce sites in the U.S., Canada, UK, Mexico, Korea and Taiwan. Total e-commerce sales for the third quarter were up 37% year-over-year. And again, that was Q3 of 36.8, year-to-date 36.1 and for the four weeks of April, which we have previously reported was up 43.1%. We continue improving and slightly expanding our offerings.

We have been helped of course by improved member service and better search and check out and returns processes, but first and foremost we’re delivering greater value to members and more people are actually are looking at it, opening their emails and transacting. This stuff works and we will continue to see – we believe to see some good results there. In the third quarter, our site traffic conversion rates and orders will continue to improve year-over-year and again we would expect that to continue at least in the near-term.

Online grocery, both our dry grocery two-day delivery and our same-day fresh delivery through Instacart both of these were rolled out last October and continue to grow nicely. Still a small percentage of the total company, we are growing and we're seeing good things from it both in existing markets, plus in some cases in markets where an existing Costco might be a little further away.

We continue to improve the online merchandise and services offerings with hot buys and buyer picks with buy online and pick up in store, some limited big-ticket items, like jewelry tapped with some laptops, and most recently handbags. One other additional comment on that is we’re seeing that plus or minus half, about half, a little under little over of those people will come in and shop as well before they pick up the item. Another example of how we’re seeing some of the stuff benefit of the benefit as I have given examples in the past, most recent probably good example is household furniture.

Historically, this was only in warehouse in generally for eight or so weeks per year. Now, it’s online or 52 weeks and we're seeing good increases in sales there, incremental sales, similar to our success in selling appliances that I have discussed in the past. Overall, all these efforts are positively impacting our business both online and in warehouse that are helping our sales momentum and increasing member awareness of our digital presence at the same time. We are seeing good traffic increases and hopefully we can continue these types of activities.

Overall, omnichannel is certainly working to enhance and increase our business. One last example, we know how in 220 of our roughly 520 U.S. locations where I'll call e-commerce product showcases and online ordering capabilities. All U.S. locations will have something in place by this year's upcoming fall holiday season.

In terms of upcoming releases, we will announce our May sales results for the four weeks ending June 3 next week on June 6, and our fiscal 2018 fourth quarter scheduled earnings release date for the 16-week fourth quarter ending September 2. This will be after the market closes on Thursday October 4, with the earnings call that afternoon at 2 PM Pacific time.

I do want to point out that last year, fiscal fourth quarter were 17 weeks, this year it is 16 weeks. So, keep that in mind as you plan in your numbers. As a reminder, last year's fourth quarter was 17 weeks as I mentioned.

With that, I'll open it up for Q&A, and Josh I'll turn it back over to you for that.

Question-and-Answer Session

Operator

Certainly. [Operator Instructions] Your first question comes from Simeon Gutman with Morgan Stanley. Your line is open.

Simeon Gutman

Hi, Richard. My first question is on the gross margin. The core on core has been roughly flattish to down a little bit low single digits, I think you said down four, I don't you don't guide to it, but I wanted to ask if that's roughly the ballpark that we should think about or is that a consequence of just how the margins of the business and the sales play out?

Richard Galanti

Starting with the first part of the question was, I know you don't want to comment on it. Look at the end of the day, there is lot of moving parts to it. All I can tell you is, we’ve been fortunate to have a few different buckets of monies to be able to do a lot of things starting with the credit card transition, continuing with membership fee increase, continuing with the income tax and you add a little too that some of the Sam's closings. All these things we were able to do. We feel very good about what we're doing and the other thing is, as you have all heard over the years, when costs are going up, we want to be the last to go up and when prices are going down, the costs are going down we want to be the first to go down.

When you look at some of the things that have happened where there is inflationary freight costs, those things generally are now in there, but we, we pride ourselves on holding off on some of those things. So, I can't really tell you where we will go at this other than we feel good about what we’re doing. Keep in mind also that some of this has to do with not just core on core, but some of the penetration, the sales penetration of things like low margin gas. We feel really good about where we are pricing wise and what we're doing with it and driving our business.

Simeon Gutman

And the 110 to 120 of pretax wage investments, do you think about investment in price any differently or the two are unrelated in the way you manage the business?

Richard Galanti

Well there are two and keep in mind, given that the income tax changes were unique and don't happen every day we certainly felt the right thing to do was to allow it certainly to help our employees as well as drive our business and improve the member value. I look at how we have done it. We feel pretty good about what we’ve done and where we’re going with it, but we don't look at and let’s take a third, a, third and a third. This is just how we're doing it. And we want to, we recognize that there is a lot of things to be able to do it, and if you go back years ago, when they looked at my comment on some will fall in the bottom line, we view that as part of the process here to.

Simeon Gutman

Okay, thanks Richard.

Operator

Your next question comes from Michael Lasser with UBS. Your line is open.

Michael Lasser

Good evening and thanks a lot for taking my question. So, when you look at the e-com transaction, how are those impacting your profitability, both e-commerce transaction itself and those that are being picked up in stores that half of those include a shop and visits to the warehouse.

Richard Galanti

Well, first of all, the buy online and shop in stores is some limited high ticket small size items, where in many cases we find members would love to buy it, but didn't want to, couldn’t have it delivered to where they worked, didn’t want to leave it on their doorstep. And what we found is, which we were a little surprised by is when they do come in, a lot of them come in and shop first and then pick it up, and shop quite a bit frankly. It’s a small piece of the business. We’re not looking to have people come in and have to refrigerate stuff while and order online and then we have got to have refrigerators and freezers filled waiting for them to come. These are limited areas where we think we can drive business and provide that member service.

Michael Lasser

And is it having an impact on your margin structure at this point?

Richard Galanti

No, not really. Keep in mind, like a lot of companies out there, we're doing a lot of things. If you think about what we're doing with the two delivery things, there is some inefficiencies are starting it up and ramping it up and buying equipment for box making and whatever else. We're not really talking about all these little things, but there is things there. But no – when we're doing some of the things, hot buys, some of that is our vendors, and some of that is - some of the monies that we have to be able to use. As I mentioned before, I think that for every dollar that we had to use, we feel we get kind of a bigger bang for that buck than others simply because of limited targeted items.

Michael Lasser

And my follow-up question is, this year's third quarter ended a week later into May and began a week later in February, so you probably got a higher volume week and gave up a lower volume week, did that calendar shift effect have any impact on your sales and profitability in the third quarter?

Richard Galanti

Not for the quarter, no.

Michael Lasser

Thank you.

Richard Galanti

Thank you.

Operator

Your next question comes from Chuck Grom with Gordon Haskett. Your line is open.

Chuck Grom

Hi, thanks Richard. On the digital front, any learnings so far from Costco grocery in particular, are you seeing a new shopper or is it an existing shop that's making an incremental purchase and then separately can you remind us of the SKU count online today and where you see it going forward?

Richard Galanti

Well on the last question on the SKU count, I think it's approaching 10,000. We don't see it getting a lot bigger, but you keep in mind over the last couple of quarters we've added lots of what I call velocity items, food and sundries items, health and beauty aid items, some apparel items, which is getting people to open their emails if you will and think about coming back more often to take a look without us having to remind them. And so, all those things we will continue to see. And I'm sorry the first part of the question?

Chuck Grom

[Indiscernible]

Richard Galanti

I think, it's really too early to tell. We clearly are getting some customers, in the case of the two day, which is dry, it covers the entire continental United States. We are picking up some members that we never had before because we are 50 to 100 miles away from the nearest physical Costco, and we're really just, and I talked in the last quarter about there has really been very limited marketing of that as we're just getting it up and running and rolling it out. We, and it is too early to tell what impact if any it has in terms of same-day grocery. Historically, we saw in some early cases back in like the Bay area, which did not refresh by the way, you saw perhaps an existing member shop a few less times that year, but shopped several times online, in some cases there is this fill-ins and they are still coming in. The sum of the two was still better, a little better than it was before. I think we will have to have see. As you might expect, we're going to figure out how to do it. So, it is not, it benefits us in some ways, that I think we're fortunate that some traditional retailers don't have that same benefit.

Chuck Grom

Okay, thank you. And then just on, it has been a while since you've updated us on your long-term club goals, just curious where you see saturation, where do you think you could see the club base looking out maybe 5 and 10 years?

Richard Galanti

Well we have to see. 21 this year is probably a few less than we had thought we will be able to get done. Some of that is couple of delays, some of it is international, it takes a little longer. Some of it is, our conviction particularly in the some of the newer countries. We want to grow people there and as you know if you look back at Japan, I think we got to 6 over in the first five years and fast forward several years, we are in the mid-to-high 20s. We got to 3 over 2.5 to 3 years, 2.5 years plus in Australia. So, I think you will see those numbers go up. If I had to guess and it is an honest educated guess, somewhere in the mid-20s over the next 5 years, probably a couple of year in business centers, 2 years to 3 years, who knows.

And in terms of U.S., on the basis of 520, today in the U.S. is somewhere in the 15-ish range for the next few years and logic will say maybe it becomes a little bit, maybe it is helped a little by business centers we will have to see. We still, we keep finding and surprising ourselves as it relates to the ability to put another unit in and even getting somebody to cut their drivetime if you will to the nearest Costco from 30 minutes to 15 minutes, can be very meaningful as we have seen in places like San José and Redmond and other places. So, we will see.

Chuck Grom

Great. And then last question, just on the groceries, you said, the core and core down four, anything unusual in the quarter was there any mix pressure or any inventory issues given some of the weather and it sounds like most of the price investments have been proactive, just wondering if you guys have done a deeper dive looking to elasticity on some of those price investments?

Richard Galanti

Elasticity is not a word we will ever use or think about. We are merchants and we are constantly driving value. I think you've heard us say before, this is all about us, who's our toughest competitor it is us. And, I think there is a little sales penetration detriment in the number and that was part of that. But again, there is lots of moving parts and pieces not just core on core but other ancillary businesses and again I got to tell you, we feel pretty good about our pricing ability and our ability to drive the bottom-line through good sales and the like.

Chuck Grom

Great. Thanks, and good luck.

Operator

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

John Heinbockel

So Richard a couple of things maybe along the lines of convenience, when you think about both this inside the box, it has been much thought about doing more items and maybe bulkier items that take up space that kind of get them out of the cart, pick them up on your way out and if so would that, do you guys think that would lead to more items per shopping trip, if people were kind of buying paper and beverage not in the box, but on the way out or in the lot?

Richard Galanti

The short answer is, no. I mean, will there be some things added to the buy online and the pick of store, I'm sure there will be few other things, but it’s not like we’re saying, hey what else can we do there. We're doing a little of that because the few things that we have done have worked, but also take something simply as bulk paper goods and bulk order. It’s kind of like where is that located in warehouses? In the back, what does that make you do? It makes you go through the whole warehouse. Not unlike having the fresh foods at the supermarket in the back, as we do as well. So, I think there is lots of different ways you can skin that cap and I don't see us doing a lot of that. I'm sure it will change and increase somewhat over time.

John Heinbockel

Okay. And then secondly, you think about, I think in the past, maybe the topic of smaller box size comes up, but you’ve always liked the economics of the large club, so if you think about maybe a box that’s half as big more convenient playing in the what’s for dinner tonight space to a greater degree does that ever become an attractive option for you or not just because the economics don't match the big box?

Richard Galanti

Never say never, but it is not on the plate right now, I mean, it’s not even on the second page of the plate. So, we feel we’ve got plenty going on in terms of regular sized boxes and big sized boxes in terms of business centers, in terms of some vertical things that we're doing like in the fresh and the protein area, some more things you want on a private label, and would delivery. I mean, we have got a lot of good – in our view good things going on and pretty happy that there is plenty of regular sized box opportunities.

John Heinbockel

Okay, thank you.

Operator

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

Karen Short

Hi, thanks. Couple of questions. I just want to clarify, I guess in terms of the tax dollars, you know you did say dollars would go to investing in price. So, I guess the first question I have is, a, you now asking about the gross margin a little differently, was that something that maybe tick up a little bit this quarter because you did mention fresh margins were down this quarter and I think they were up in the prior quarter, or should we kind of expect to see a little bit more pressure on the core gross margin going forward as you do take those dollars and invest?

Richard Galanti

I cannot tell you where it'll go in the future. What I can tell you is that it is not just the tax dollars, it is the credit card, it is the mem fee increase. There is a lot of things going on out there and we have been able as freight costs have skyrocketed in the last year for everybody to hold that a little bit, absolutely. Ultimately, we have got to catch up on that and we feel comfortable holding it and catching up at some point as we have. And so, I think we feel, all I could tell you is, we feel quite comfortable as to what we're doing and how we're doing it, and that we feel very comfortable that we are our own toughest competitor and we control those about a little bit at this point. We don't know what’s going to happen in the future, but I don't think that’s changing very quickly as we come up with new things to do.

Karen Short

Okay. And so, I guess I was also wondering, I mean obviously you’ve had unbelievably strong sales now going on almost a year, but more recently I guess what I'm wondering is, do you think that the strength in sales is just a function of strong or not that you weren’t executing before, but stronger execution and price points or do you think there is some benefit that you're seeing from a consumer perspective from tax dollars, tax refund dollars in their pockets, do you have any color on that?

Richard Galanti

The only color we get is, it relates to tax reform dollars is what we – what you and I and others here and read in the paper. As you hear from some economists, certainly we've heard from some of our business partners whether it is the credit card issuers and networks or other types of third parties. And it seems like there is a little there, but it's hard to really dictate that. We know that pricing, investing in price works, and we know that it tends to work generally very well such that even in working with suppliers and in some cases, we will partner with them to get to that do just a lower price point as it drives more volume, you know not have to take on any of that ourselves.

So, there's lots of different ways to do it, but I think that one of the things that we have commented on of course is also some of the low hanging fruit and benefits that we have because of the things we hadn't done historically. You look at the examples of appliances and look at the examples of furniture, used to be if you wanted to buy household furniture items, if you don't have a truck you will get one and call your friend because we don't deliver. That has changed anyway, but even so we're still doing very well in-store for those 8 or 10 weeks of this example, but all of a sudden, we have got 40 plus more weeks where we are doing truly incremental business in the hundreds of millions of dollars and growing. Those are the things that I think that make us additional, it's not just price, price is in the top of our list, but beyond that there is other things that I think are benefiting us. Certainly, fresh foods and what we have done there in terms of the quality and the consistency and coming up with new items.

Karen Short

Great. Okay. And then last question from me, just inflation at core and at retail at this quarter?

Richard Galanti

I think on the food and sundries side, it has picked up a little bit, and again talking to the buyers is a big chunk of that has to do with freight and I think one of the analyst reports out there and the title is called frightening changes to cost, but at the end of the day it rains on all of us and I think on the food and sundries side it was up in the 2% to 3% range and probably two-thirds of X it was more related to freight related costs.

Karen Short

And that's at cost or at retail and both?

Richard Galanti

That's at cost. Needless to say, if there is 35%, 40% of your business, 200 or more cost basis and core or core is down four, ultimately you got to pass that on, and ultimately, we have some additional monies to be able to use towards that to be more competitive and so.

Karen Short

Okay. Thanks.

Operator

Your next question comes from Peter Benedict with Baird. Your line is open.

Peter Benedict

Hi, thanks Richard. The move on wages, is that, does that effectively pull forward what you might have done or what was likely to happen, I guess next spring when I think you guys do for the next employment agreement?

Richard Galanti

If you look back over many, many years. We have a three-year employee agreement. The last one was March 2016. So, the one important thing in there of course is where do our topics scale hourly employees move each March of 2017 and 2018 and 2019, that’s prescribed in that March 2016, new employee agreement. And so that’s prescribed, and historically we’ve always done something in top of scale. I don't see that changing. We have once or twice moved the bottom of the scale up. We will see where tomorrow brings, this probably won't be the last time, particularly and so we will have to see, but we, I don't, we really looked at it independently of that, ultimately if you're going to do something and if you're doing something now, it doesn't mean you're not going to do something on top of that next time and again I am not trying to be coy. I expect whatever most people are going to do we're going to do a little more.

Peter Benedict

Not that make sense, a quick question on the competitive tone in the market, I mean you just got done saying earlier that you're always your toughest competitor, but maybe can you comment on what you're seeing as you guys are looking at some of your competitors or the big club or non-club with all these tax dollars moving around or are you noticing them being sharper in any areas?

Richard Galanti

You know, I honestly believe while there has been some, I think all companies, not just in retail tend to, I am sure many companies feel that one there is a desire to use some of this to help employees to share that wealth if you will, to drive their business. I don't think it has been life changing for any company, and since that, one of the questions we were asked right after the announcement that we said that on an annualized basis next year, if you do simple map roughly 7 percentage points of our effective rate from the 35-ish to the 28-ish on you take the pretax dollars it is some low $300 million after tax benefit.

And somebody asked a question about does that mean you might do a special dividend? Well our special dividends, the three that we’ve ever done are the $2 billion to $3 billion cost range. So, this really doesn't change anything there. We’re already generating cash flow to do other things, and maybe we are in the higher quartile then we will position financially, but I think overall [indiscernible] from what I have read does it help the consumer? Sure, it helps the consumer. Some of the consumers as employees are benefiting from it and all that is good. Certainly, competition in general is benefiting consumers in terms of pricing. We are fortunate that pricing mode continues to widen to our benefit.

Peter Benedict

Okay, thanks for that and my last question is just around the executive membership numbers. Those were growing, call it high single digits in the past, even last year, this year they are starting to grow more like mid-single, some deceleration there, can you just talk about maybe the opportunity to continue to grow executive membership here in the U.S. and then thoughts on maybe when you could be adding that to some newer markets internationally? Thank you.

Richard Galanti

Sure. Well in terms of total membership we feel again pretty good about it is probably depends on when you are opening and where you are opening and the last couple of quarters we have opened three units I think in the last two quarters, we got a bunch coming. It also depends where you are opening. As you know, I've given the examples of where we have done and infill in a very strong market like San Jose area or Redmond, Washington area in Seattle. We might average in 3 existing locations 60,000 or 65,000 members per building at only 3,000 to 5,000 new members in that new building but add net of cannibalization $100 million to $120 million of annual sales in the first new year, first 12 months of that new opening. And so that is all about being close to your customer and driving more business. What was the first part of your question again?

Peter Benedict

[Indiscernible] how much core opportunity in that internationally?

Richard Galanti

I'm sorry. The other thing is as we have said that you are aware of, in international we tend to do outsized number of signups. Again, there has been as many as right now. Lastly, I mean we have done, I think in the past three or four many social group on type activities and they were quite well, so well that we don't want everybody to get used to it, so we don’t do that often. We actually just started one yesterday for a two-week period, and so that will help a little bit this quarter as we are opening 13 or whatever number of new units, as we are opening a couple more international ones. So, all those things, when we look at, one of the questions we have been asked in the last couple of quarters was membership, new membership growth has slowed a little bit.

When you look at existing warehouses net of cannibalization take out all the cannibalized units that where new and the ones that those new ones cannibalize in those markets. We are still seeing a number in terms of member growth per warehouse in the high threes, mid-to-high threes I believe, 3.7, 3.8. I think it was 4 six months ago. That certainly gives us comfort and we feel it should give you. In terms of executive, I think on a weekly basis forever it seemed like it was like 20,000 a week, 22,000 a week, I think there are a couple of quarters where it was in the mid-teens or maybe in the low double digits. So, it has come back from that to 2019. In terms of, some of that is ultimately you do saturate a little bit, but part of it also, in terms of new countries, we currently operate in U.S., Canada, UK and Mexico, and I think if you just looked at simply how many units we have in each of those markets, certainly Mexico and U.S. is not an issue. We are in the low-to-mid-30s in the UK, and in low-to-mid-30s in the Mexico. And part of that is you need kind of a critical base because of the services that you offer that also is not just a 2% reward, it is the services you offer for it. I would guess that you will see in other countries, and that will help a little bit in terms of driving that, but probably more will come from us driving the value of it.

We have seen some improvement when people realized that, if I sign up for the Executive Member Card and I sign up for the co-brand Citi Visa Card that’s not only the 2% from Costco, but the 2% from – on the average or whatever it is from Citi Visa and if I buy a TV that way it is a four-year warranty not a two-year warranty. So, all those things get people, the card business, I mean last year we represented over 0.5 million new car sales and if you were an executive member in some of those marketing items, you got a cash card that was a few hundred dollars more than if you were a Gold Star member. Rest assured that there were people that converted for that reason and once they did, they start to look at the other benefits of it. So, all those things help. We do a better job when you sign up of getting you to sign up as an executive as best as we can.

Peter Benedict

Okay. Thanks, so much Richard.

Operator

Your next question comes from Kate McShane with Citi. Your line is open.

Kate McShane

Hi. Thank you for taking my question. I know this has been asked a couple of times, but I just want to ask it maybe in a little bit different way, but with the level of cash that have come in from the membership increases and in the tax reform, do you think your price investment is going to result in greater gap historically, given the amounts that you've been able to invest?

Richard Galanti

I think, they have. I mean, on a general picture, if you look at just the traditional grocery industry, there's more competition generally out there and have others come down in certain pricing, I think, a little. Have we come down more, yes. This is an old statistic, but I remember looking at traditional grocery markups and recognizing there's been some product additions that are higher-margin items, especially items of supermarket industry over time.

But over 20 years, this goes back a few years ago, so five years ago and 25 years ago or whatever, it seemed like generally speaking, the grocery industry was going from markups that had been in the very high teens or low-20s to the mid and high-20s. And the big home improvement companies had gone from the high-20s to the mid-30s in what is our gross margin and our markup has done, it has gone up from 10 to 12.

And in fact, it has gone up from 10 to 12, despite the fact – and some of that is not quite right. Some of that is some higher-margin businesses like travel, which has very little cost of sales, or some of the ancillary businesses like pharmacy and optical that have very little cost of sales. So relatively speaking. Cost of sales got higher markup to cover the cost of pharmacists and optometrists or what have you. So, I think, with all said and done, in our view, just looking at the pricing gap, we've done stronger. And I think we get a little more kick out of a dollar used in certain ways than perhaps others that we're fortunate in that regard.

Kate McShane

Okay, great. Thanks. And my second question was just on the international business. I wondered if you could remind us of the timeline or your expectation for profitability for France, the newer stores in France and Spain to be profitable?

Richard Galanti

Yes. I think at the store level in Spain, we’re there – we’re pretty much there or very close. And mind you, we charge, we own many of these locations around the world. We own 80% - around 80% of our locations. We charge a higher than current market rent factor internally just to have everything and look at all warehouses on the same schedule and I’m talking about after that imputed rent factor as well. But on a store contribution level, yes. France is brand-new. Iceland is a unique brand-new in the last couple of years. Iceland is unique, because it's just been a great market for us.

So, it's done better than planned. The others are pretty much of an implant. We – if I go back, again, number of years ago, our original budget in Japan is 20 years ago was open five units and five years and we break-even or start profitability towards the end of your five or early six. We ended up opening six, and I think we were profitable near the end of – right before the end of year four. These are rough numbers. But at the end of the day that includes the cost of a central operation that's not going to grow as you go from two units to 10 units in a market, it's going to grow a lot less than five-fold.

And the pre-opening cost of a new unit and then the fact that you're also building your business. We start with a slow volume building as expected in some new countries, not all new countries. You’re pricing your fresh foods as if you're doing a lot more business and you know, you're going to have some cases very low or negative gross margin sometimes of those. So, I think the timeline we're patient. We're also not going into any market and trying to get 10 or 20 openings in one year or two years. And so, it's – I think, we've done a decent job of balancing that process.

Kate McShane

That’s very helpful. Thank you.

Operator

Your next question comes from Dan Binder with Jefferies. Your line is open.

Dan Binder

Thanks. I’m Dan Binder. I had a couple of questions. First was on…

Operator

Jefferies. Your line is open.

Dan Binder

Can you hear me?

Richard Galanti

Yes, I can hear you.

Dan Binder

Okay.

Operator

Your next question comes from Chuck Cerankosky from Northcoast Research. Your line is open.

Richard Galanti

Hey, Josh? Can you hear me, Josh? Josh?

Operator

Chuck Cerankosky from Northcoast Research. Your line is open.

Richard Galanti

Josh?

Chuck Cerankosky

Richard, I can hear you. Well, this is Chuck Cerankosky.

Operator

Our next question comes from Laura Champine from Loop Capital. Your line is now open.

Richard Galanti

Somebody, call him. Hold on, we’re having problem with some third-party here. But Chuck why don’t you go because my guess is everybody else could hear us.

Laura Champine

I’m not sure he is on. It is Laura Champine, which one of us can you hear?

Richard Galanti

I can hear Laura now. So, we’re going to – [indiscernible].

Operator

…Kelly Bania with BMO Capital [indiscernible]. Your line is open.

Richard Galanti

Okay, guys, hold on a second. I am just calling him. Just hold on a second.

Operator

Bania, your line is open.

Kelly Bania

Hi, Richard, it’s Kelly. Can you hear me? Should I go ahead or do you want to…

Richard Galanti

I would wait, because I don’t think Josh can hear you.

Kelly Bania

So, no problem. Sorry, I can hear you.

Richard Galanti

I think Dan Binder was the first one that did not - Dan Binder is the first one that you couldn’t hear, but we could hear. So, can we go back to him.

Operator

So, you just have to get them to requeue up and I’ll promote them again.

Richard Galanti

Okay. Thank you. So, go ahead.

Operator

You’re welcome.

Richard Galanti

Put I back to you, Josh. Who’s next?

Operator

I’m sorry, this is Kelly Bania from BMO Capital.

Richard Galanti

Okay.

Kelly Bania

Okay, thanks. Thanks, Richard. Just wanted to first ask on quickly on gas, did you clarify the impact from just the mix of higher gas prices versus the actual gas margins?

Richard Galanti

We didn’t – margins in terms of dollars, margins were down and we made it up in volume. And so, profitability was pretty even year-over-year.

Kelly Bania

Got it. Okay. And then just also wanted to go back to the comments on the food and sundries, inflation – the cost inflation, I guess that's way driven. Are you seeing any acceleration in that? Are you not quite passing all that – all of that along? Do you see your competitors passing along? Do you see that kind of accelerating as more of these vendors that maybe our feeling or starting to push that through?

Richard Galanti

Well, I think, a general comment would be as is, what – whatever input – cost input item is inflationary we're going to hold off longer than others, but ultimately, you've got to do it. And we like any other retailer would push back to the vendor and try to figure out smarter ways to do things. And – but overall, I – it's a small delay. Don't – we're noble, but we're not crazy, so.

Kelly Bania

I guess, do you think – I mean, do you think this could result in some just broader food inflation over the next several quarters? That was just we haven't seen in the long time.

Richard Galanti

I think you'll see that generally. I mean, if costs are up 2% to 3% input cost on the food and sundries side, a big chunk of that is freight related. Ultimately, that's going to compel. Now some of that will also compel to private label in some cases. In our case, we generally see this as a positive because we can be a little tougher on pricing in terms of being – and being more competitive.

Kelly Bania

Got it. And then just one more on the online grocery, the non-perishable's offering.

Richard Galanti

Hold on. [Indiscernible] Josh?

Operator

Yes.

Richard Galanti

We had a couple of calls externally here that people in our office that are – they cannot here the call all of a sudden, so while we continue here, can you check, see what's going on there?

Operator

Certainly, not a problem, I'll look into that for you.

Richard Galanti

Okay. Thank you. Go ahead, I'm sorry.

Kelly Bania

Okay. I'll ask one more, maybe while others are getting back in queue. Just on the non-perishable's offering, how do you feel about the process of fulfilling those and scaling that over time? Do you think you need anymore – any sort of automation technology to fulfill those orders and make that profitable longer-term, or are you happy with the way that process is working?

Richard Galanti

Well, first of all, this stuff is profitable. It's small, it's growing nicely. But it's – we have capacity within our business centers, which we already set up to do buy online and actually deliver this way. It's just you had to buy some box-making machinery. And the good news for us is that, we feel that, A, there yes. Ultimately, God willing, we'll have to build new facilities or additional facilities for this.

Just like when we started, we had one e-commerce fulfillment facility in Mira Loma that covered the whole country years ago. And so, yes, there's a trade off. But I think that, A, we feel very good about how we're doing it that we can be profitable almost from the start other than things we're doing to invest and driving the business and marketing it and things, and it will be fine. Again, I think, we're fortunate in that regard with so few items, it's lot easier to do these things.

Kelly Bania

Thank you.

Operator

Your next question comes from Dan Binder with Jefferies. Your line is open.

Dan Binder

Hi, it's Dan Binder. Thanks. Thanks, because if you are getting me back in the queue there. I had two questions. First was on the benefit that you're seeing in clubs where you've had competitor closings. Obviously, there were a lot. So I'm just curious what you're seeing in terms of the comps benefit and the membership benefit?

And then my second question was around price investment, a little bit different angle. Just trying to understand more about couponing versus everyday low price. I think, it was probably a year or so, maybe a little over year ago, where you had backed off, I think, on the vendor items a little bit that hurt the comps and then you kind of brought it back. I'm just curious as you think about price investment going forward, will it be more through the vendor mailer or more through EDLP?

Richard Galanti

Well, first of all, if we go back to – just to clarify one thing. If we go back to – it was Q2 of last year when there was a little disappointing and a lot of it had to do with is the stuff that we did to change the MVM and take some items and test with vendors everyday low pricing or – and some greater values, but still be at the table in the MVM, maybe a few hot picks as well. And more of the offset to that that we didn't anticipate on a negative standpoint was fewer MVM days.

So, if you went down, I think, it was the four week reporting month of February of 2017, 28 days. We had eight less MVM days. The MVM items themselves did as expected more lift, more value to the member and less gross margin per item, but more gross margins dollars to us. So that work nice. But by having those significantly fewer days of having something that is a promotional thing that gets member in the door and we change that. It took us two months to change that and since then it's been fine and, of course, it's gotten better than that since then.

I don't think there's any magic. If there were an exact formula that we knew, we would tell anybody. But at the end of the day, we keep trying different things with different vendors and see what works and doesn't. I think, we have kind of settled on a mix that it includes all of the above and we'll keep them trying to figure out how to drive that in different ways.

So again, I don't see there's a big shift. The shift was over a couple of years perhaps leading up to a February of 2018 or the late calendar 2016, there was over 20 years some of the stuff gets – some of the sales lifts of an item gets a less people waiting for that regular thing every twice a year for three weeks waiting. And so, a, the values have to be greater to drive more lift and, b, we got to shake it up a little bit.

And I think it's – the good news is work with vendors. We're not just forcing vendors to try something, try one thing versus another. We're working with our vendors hopefully that do well for both of us and even partner with them when there's a little indigestion on how much additional savings. And so we can show them the type of unit lift that will be – that will generate and sometimes that works and sometimes it doesn't [Technical Difficulty] were a couple or three Sam's closing in the existing Sam's market. So they were just adding a lot of those sales to other units they already had.

Our view was as we get 10% to 20% of it and we have of what we guess their sales would be. Some of it is not our member. Some of it is – we're too far away from that member, maybe that was on the other – it was 10 miles from the other side of the existing Sam's Club and we’re 10 miles, the other way is now 20 miles just too far. In some cases, the business went to another existing Sam's in the market.

We definitely saw some benefit in the membership, number of members. Again, not huge, but certainly helps and…

Dan Binder

Great. Thanks.

Operator

Your next question comes from Chuck Cerankosky with Northcoast Research. Your line is open.

Chuck Cerankosky

Hi, Richard. Going on a little update on the food manufacturing projects you have underway. The construction, where is that at? And then I want to ask another question about the online.

Richard Galanti

I’m sorry, ask that first question again?

Chuck Cerankosky

You’ve got a couple of food plants under construction, where are we at on those and in the special opening days?

Richard Galanti

Well, the bakery commissary in Canada is open and running. I would say, it will take a year plus to get it to increase capacity and everything. But that's going as planned. Our chicken plant in Nebraska is a year-and-a-half away, a year plus, it's under construction. But it’s all planned on a relative term in terms of we know it's going to take a year plus to get there, but it’s doing fine. Anything else, guys?

Unidentified Company Representative

[Indiscernible]

Richard Galanti

We opened outside of Chicago in March, Illinois, a second meat plant, basically a sister plant, if you will, in the one in Tracy, California that we had forever. And the good news there is the Tracy one along with the added capacity at the hotdog plant at the same property location were at capacity basically and we pushed that over.

Chuck Cerankosky

Okay. You mentioned before you had 10,000 SKUs online. Is that the count all the time? And then when you look at how you remerchandise the online assortment over the course of the year? How often are you changing that? It seems like the e-mail and promotional activities picked up. But what is the cadence to refresh the mix in assortment that you have?

Richard Galanti

Well, look, I think, A, it's not unlike in warehouse. The exception is, of course, online. We want to be a little resistant to just climbing, because it's virtually easy, because it still has cost. We've added velocity items. We've added sundries and some shelf-stable items to delivery, that's another avenue as well. I think, it will ebb and flow. Don't expect any great change to what you're seeing now other than a constant evolution of that.

The other thing is, in some cases, there's products and vendors that will sell us online that weren't prepared to sell certain things in store. And sometimes, you'll have to be a member to get to the price online at Costco, which is fine. Our member understands that and they're going to to and see it.

Chuck Cerankosky

All right. Thank you.

Richard Galanti

I'm going to take two more questions.

Operator

Your next question comes from Laura Champine with Loop Capital. Your line is open.

Laura Champine

Great. Thanks for taking my question. On the private label business, I mean, obviously, a lot of clubs have been streamlining the number of brands they offer. Kirkland has used almost throughout Costco. But there are some other brands like the Charisma and some of the textiles. Why not go for Kirkland across the Board? And do you have goals on how much of your sales you'd like to drive through that private label brand?

Richard Galanti

Unfortunately, our head merchant is traveling to an opening today in California or is that an opening day in California. I'm not sure and in my mind, Kirkland Signature is it to the extent there's a brand called Charisma, but it's not our brand. I know it's not – the way it's not our brand. Now maybe it's a brand it's not as well noticed as others, but that's not our brand. Kirkland Signature is the only brand you can see in Costco.

Laura Champine

Got it.

Richard Galanti

As it relates to how much, what I guess it's Kirkland Signature label but excluding that, which is 10%-plus of our sales. It's about 25% - 24% plus of our sales, where we wanted to go, I don't know where we wanted to go. We'll increase, yes. Years ago, I said, well, you'll never see it on this and then now it's on that. But at the end of the day, we still want brands and we still cover it and our members certainly value brands as well. In our view, it enhances our brand value. But there's a 24, it keeps increasing to the 25 and 26, and 27, I'm sure it will, but I can't tell you how long that will take.

Laura Champine

Okay. Thank you.

Operator

Your last question comes from Brian Nagel with Oppenheimer. Your line is open.

David Bellinger

Hey, Richard it's David Bellinger on. Just a couple of quick questions. Can you talk about regional performance in the quarter? Any weather impact on traffics that you can call out specifically? Was there any improvement towards the end of the quarter?

Richard Galanti

There weren't a lot of weather related comments eventually hold on we're still looking, real quick. It really wasn't that impactful to us.

David Bellinger

Okay and I'll just follow-up on margins as well. It seems that the major drag came from the higher gas prices this quarter. But can you help us frame what percentage of sales gas represented this quarter, I know you just mentioned was on annual basis like above 10%. If you want to get too specific can you just give us some indication how that's changed over the past few quarters and how that impacted here in Q3?

Richard Galanti

Yes, we really don't go into that level of detail. Generally speaking with gas prices go up we will make a little less margin, when they go down we make more margin, happy that they went down yesterday a little bit. But at the end of the day, it's been a good business for us in its own right as well as driving business into our warehouses. It's about 10% to 12% of our business. And I think that the thing that we like to see is, when you have total U.S. gallon gas consumption as a country everywhere be up in the very, very low single digits, our gallon increases are in the very, very high single digits or very, very low double-digits. And so that's meaningful that means that more people are coming into our place and with about half of them come into shop, you don't need more than one or two of those 50 out of every 100 to be somewhere, but incremental shop to be meaningful to our company on an ongoing basis. Aside from the business itself having a little strong [indiscernible] based on the volatility sometime day-to-day and week-to-week, but profitably, but overall it's been a good business in its own right.

David Bellinger

That's helpful, thanks for squeezing me in. I appreciate it.

Richard Galanti

Thank you. We're all around guys and feel free to call with any additional questions, we'll be here tomorrow as well. Thank you.

Operator

This conclude today's conference call. You may now disconnect.