Costco Wholesale (NASDAQ:COST) F1Q 2014 Results Earnings Call
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Executives

Richard Galanti - CFO

Analysts

John Heinbockel - Guggenheim Securities

Paul Trussell - Deutsche Bank

Meredith Adler - Barclays Capital

Michael Montani - ISI Group

Matthew Fassler - Goldman Sachs

Jason DeRise - UBS

Chuck Cerankosky - Northcoast Research

Scott Mushkin - Wolfe Research

Charles Grom - Sterne Agee

Michael Exstein - Credit Suisse

Peter Benedict - Robert W. Baird

Budd Bugatch - Raymond James

Operator

Good morning. At this time, I would like to welcome everyone to the Q1 earnings conference call. [Operator Instructions] Thank you. I would now like to turn the conference over to Richard Galanti. Please go ahead sir.

Richard Galanti

Thank you, operator, and good morning to everyone. This morning's press release reviews our first quarter earnings results for the 12 weeks ended November 24.

As with every conference call, I'll start by stating that the 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, 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.

To begin with, for the quarter our reported earnings came in at $0.96 a share, compared to last year's earnings per share of $0.95. Several items of note that impacted the year over year comparison. I'll go through six items.

Membership fee increase, as I've been mentioning for the last many quarters, the fee increase that we did in the U.S. and Canada in late 2011 and early 2012, that benefited this first quarter earnings by about $8 million pretax, or $0.01 a share. That will be the tail end of the benefit of that increase showing in our numbers.

Interest expense was higher year over year in the first quarter by $14 million pretax or $0.02 a share. This of course related to last December's $3.5 billion debt offering in conjunction with the $7 per share special dividend.

FX, in the first quarter the foreign currencies we operate in weakened versus the U.S. dollar, primarily in Canada and Japan. This resulted in our foreign earnings in the first quarter, when converted into U.S. dollars, being lower by about $14 million pretax or $0.02 a share than those earnings would have been, had FX exchange rates been flat year over year.

Gasoline profits, gas is a very good business for us. It drives frequency, we feel, and year over year it's always profitable, although it tends to be volatile. And the first quarter that impacted earnings by a little over $0.02 a share.

Stock expense, that's a line item that we have in our SG&A, it was higher year over year in the first quarter by a little over $0.02 a share as well. We have over 4,000 people, generally managers and buyers and above, who receive restricted stock units as a significant part of their annual compensation.

Such grants are made annually each October, or in our first fiscal quarter. These RSU grants then typically vest over a five-year period, with accelerated vesting when a recipient reaches 25, 30, and 35 years of employment with the company.

Now, factors driving this increase included a 24% increase year over year in our stock price on the dates in which the RSUs are granted each year, additional levels of accelerated vesting given many employees' long tenure with the company, and a large number of employees in the plan.

I should note that this past October, our RSU grants were reduced by an average of around 15%. That is, the number of RSUs granted to each recipient. The increased expense occurred, of course, notwithstanding that reduction.

IT modernization, talk again about that. We're in our probably second full year of a major modernization effort. And as discussed in the past several quarters, these efforts will continue to negatively impact our SG&A expense percentages throughout fiscal 2014 and probably a little beyond that, especially as the new systems are placed into service and depreciation begins. In the first quarter, on an incremental year over year basis, these costs impacted SG&A by about $12 million or about 3 basis points.

Turning to our sales for the first quarter, our 12-week reported comparable sales figures for the first quarter showed a 3% increase, 3% in the U.S. and 1% internationally. As indicated in our release, excluding a gas price deflation and the impact of FX, the 3% reported U.S. comp would have been 4% for the quarter. The 1% international would have been up 6%, and the over 3% for the company would have been plus 5% on a basis excluding gas deflation and FX.

Other topics of interest, opening activities and plans, we opened 13 locations during the first quarter of fiscal 2014, 9 throughout the U.S., 1 in Alberta, Canada, 1 in Monterey, Mexico, our third in that city, and 2 new units in Australia, bringing Australia now to 5 total units in operation.

During the fiscal quarter, one location was closed, in Acapulco, Mexico. This was due to the extensive damage that resulted from the severe flooding down there from Tropical Storm Manuel. That may or may not reopen this fiscal year, but most likely certainly in calendar '14.

Since the end of the first quarter, we have opened in Q2 two new locations, one in Illinois and one in Canada, in Ontario. That gives us 15 new openings thus far in fiscal 2014. For the entire fiscal year, we have a current plan of 30 new locations, 16 of which are planned for the U.S., 4 in Australia, including the two we recently opened, 3 in Canada, 2 each in Korea, Japan, and Spain - and of course those would be our first two units in Spain - and one additional location in Mexico.

I'll also discuss later in the call ecommerce activities, membership trends, and of course a discussion on the components of margin and SG&A.

Again, quarterly results, total sales were up 5% to $24.5 billion. On a comp basis, a reported 3, which again, excluding gas deflation and FX, was a 5 on a normalized basis. In terms of the 3% reported comp, that was a combination of an average transaction decrease of 2%, actually up almost 1% excluding deflation and FX, and an average frequency increase of just under 4.5% for the quarter.

In terms of sales comparisons geographically, for the first quarter, the better performing regions in the U.S. were in the Southeast, Midwest, and Texas. Internationally, in local currencies, the better performing countries were Canada, Mexico, and Australia.

In terms of merchandise categories for the quarter, for the first quarter, within food and sundries, candy, deli, and refrigerated were the relative standouts. Hardlines was probably the most challenging category. Majors came in negative for the quarter, challenging of course in televisions and in cameras. And better-performing departments within the hardlines were office and automotive, but slightly negative overall for the department.

Within the low double digit softlines positive comps, small electrics, apparel, and jewelry were the relative standouts. And within fresh foods, comps in the mid singles. Better performing departments included produce, meat, and deli.

Moving down the line items of the income statement, in the first quarter, membership fee income came in at $549 million or 2.24% of sales. That's 7.3% or a $38 million increase versus the first quarter of last year, and as a percentage of sales, up 4 basis points. As I mentioned earlier, that did include the extra $8 million, the first time that incremental benefit from the fee increase we did almost two years ago.

In terms of membership, we continue to benefit from strong renewal rates. A little over 90% in Canada and the U.S., and just under 87% worldwide, continued increased penetration of the executive members, and of course the benefit I just mentioned, from the fee increase.

Our new membership signups in the first quarter companywide were up 17%. That's of course due to the fact that we opened 13 units this year in the first quarter versus 9 a year ago, and this year's first quarter included three international openings, which tend to have higher signups at opening.

In terms of number of members at Q1 end, Gold Star members came in at the end of the first quarter at 29.6 million, up from 28.9 million 12 weeks earlier, at the end of the fiscal year; Primary Business at 6.7 million, up from 6.6 million 12 weeks ago; Business Add On at 3.5 million each.

So, total total member households, which, at the end of the fiscal year had been at 39 million even, came in at the end of the first quarter at 39.8 million. So, all told, we have 72.5 million card holders out there at the end of the first quarter, from 71.2 million at fiscal year-end.

In terms of paid Executive members, they stood at 13.9 million of those totals, an increase of about 330,000 during the quarter, or a little over 27,000 new Executive members per week increase. They represent about 35% of our member base now, and over two-thirds of our sales.

In terms of renewal rates, as I mentioned, they've continued to be strong. Our total membership eked up a little bit from 90.0 at the end of fiscal year to 90.2 worldwide, and worldwide from an 86.3 to an 86.5.

Going down the gross margin line, our reported gross margins were up 13 basis points, up to 10.81%. As usual, I'll ask you to jot down four columns and six line items. Basically, the first two columns would be reported for the entire fiscal year of '13, and then the second column would be also for the entire year fiscal '13, but without gas. And then for the first quarter, columns three and four would be reported and then without gas deflation.

Going down the lines, the core merchandise year over year, ancillary businesses, 2% Reward, LIFO, other, and total. So again, going across, core merchandising for the fiscal year, fiscal '13 versus fiscal '12 was lower by 4 basis points in both of those columns. Ancillary businesses was better in the fiscal '13, plus 6, in both of those columns. 2% Reward, minus 2 in both columns. LIFO, plus 5 basis points in both columns. Other, plus 2 in both columns. That was a nonrecurring legal settlement, which benefited our margins last year. And the total fiscal '13 over fiscal '12 was up 7 basis points, both on a reported basis and without gas.

For the first quarter, merchandise core reported was up 12, but without gas deflation up 3. Ancillary, up 5, but without gas, plus 2. 2% Reward, minus 3 and minus 2. LIFO, minus 1 and minus 1. Other, zero and zero. So again, total reported for the first quarter year over year and the first quarter was 13 basis points up, but taking out gas, deflation was up 2 basis points.

Now, the core margin, in terms of core merchandising the component gross margin being up again 12, but 3 excluding gas. Both food and sundries and hardline subcategories were up in basis points year over year, while softlines was down slightly year over year and fresh foods had lower year over year gross margins as well.

Ancillary business gross margins were up, as I mentioned, 2 basis points without gas. Ecommerce, business centers, and pharmacy also showed higher margins year over year, offsetting slightly lower gas margins.

Our 2% Reward, again increasing sales penetration in that, and therefore increasing Executive member rewards, caused a 2 basis point year over year reduction in margin, due to the reward program. And LIFO, last year in the quarter we had a $2 million LIFO credit. This year, there was a very small LIFO charge of about $1 million, so about a 1 basis point swing year over year.

Moving on to SG&A, our SG&A percentage in the first quarter was higher or worse by 17 basis points, coming in at 10.22% this year in the first quarter, compared to 10.05% last year in the first quarter. Again, we'll do the same four columns, reported for all of fiscal '13 and then without gas, and then columns three and four reported for the first quarter year over year and then without gas for the first quarter year over year.

In terms of operations, in the fiscal year both columns are the same, columns one and two, zero and zero for operations; central, zero and zero; RSUs, or stock compensation, minus 3 and minus 3; quarterly adjustment, plus 2 and plus 2, for a total in fiscal '13 SG&A was higher by 1 basis point or minus 1 year over year.

Columns three and four, operations on a reported basis was 9 basis points of that 17, minus 9. Without gas, zero. Central, minus 3 and minus 2. Stock or RSU compensation, minus 5 and minus 5. No quarterly adjustments. And then again total minus 17 or 17 basis points higher year over year in the first quarter. And again, without gas, minus 7.

Now, core operations, again, was flat, excluding the impact of gas deflation. Within operations, our payroll SG&A percentage was actually 2 basis points better year over year, while benefits, workers comp, and related expenses were about 4 basis points worse year over year. So those are the two big factors within SG&A [unintelligible].

Central expense was higher year over year, 2 basis points without gas, again primarily related to the increased IT spending as we continue our modernization efforts. This, as I said, will continue to be a drag on SG&A, especially as the new systems are placed into service and depreciation begins.

And finally, SG&A expense related to stock compensation, as I mentioned earlier, I won't go through the detail again, was 5 basis points year over year.

In terms of preopening, $6 million higher, coming in at $24 million in the first quarter. Last year, in the first quarter, we had nine openings. As I mentioned, we had 13 opening this year, so no real surprises there.

All told, reported operating income in the first quarter totaled $639 million last year and was up to $668 million this year, an increase of $29 million. And I won't go through the items I mentioned earlier.

Below the operating income line, reported interest expense was higher versus last year, coming in at $27 million, up $14 million from last year's $13 million in the quarter. That's essentially the $3.5 billion debt offering we did and the interest expense associated with that. We did that, I believe, in mid-December, so there will be a little bit of a year over year negative impact in Q2, and then there will be no delta year over year.

Interest income and other was lower by $2 million in the quarter, coming in last year at $20 million, and this year at $18 million. Actual interest income component was slightly up, while the other component was slightly down, nothing of size to mention.

Overall, pretax income was up from $646 million last year in the first quarter to $659 this year. Below pretax, our effective tax rate this quarter came in at 34.6%, or about 0.2% better or lower than last year's rate of 34.8%. I think most of it relates to the various discrete items that impact each year, and so a little bit of an improvement there.

Overall, net income was up $416 million last year to $425 million this year in the first quarter.

Quick rundown of other topics. Our balance sheet, of course, is included in today's press release. In terms of depreciation and amortization for the first quarter, it was $231 million. One of the metrics we always talk about is our accounts payable as a percent of inventory. On a reported basis, last year it was 108%. This year, in the first quarter, it was 99%.

Now, both of those numbers include quite a bit of non-merchandise payables, particularly as we ramp up expansion, so construction payables, if you will. If you just look at merchandise accounts payable to inventories, last year's 108 was a 94, and this year's 99 was an 89. I'll talk about that in a moment, why that came down a little.

Average inventory per warehouse last year in the first quarter was $13.2 million. This year, in the first quarter, it was up $1.2 million to $14.5 million, or up about 9%. Both of those AP ratios and the higher inventories is, for the most part, because of how Thanksgiving fell one week later in the calendar this year. So the first week of Q2 versus last year it was the last week of Q1. Much of that excess has since been burned off, and talking to the senior merchants, their view is no issues with inventory levels going into the last few weeks, before calendar year end.

In terms of capex, for the quarter it was $572 million. Capex is estimated to be about $2.4 billion this year, compared to $2.1 billion last year, the higher year over year spend, of course, due to the increased level of planned openings.

In terms of dividends, our quarterly dividend remained at $0.31 a share or $1.24 on an annualized basis. Based on shares outstanding, that's about a $540 million annual expenditure.

Costco Online, we're now in four countries, U.S., Canada, U.K., and most recently Mexico. Mexico ecommerce commenced operations in late October. For the first quarter, sales and profits were up over last year. Q1 ecommerce sales were up 24%. And excluding, again, the relative recent smaller startups in the U.K. and Mexico, U.S. and Canada, the quarter was up 22%.

And ecommerce still is a relatively small part of our company, running about 2.5% of our total sales. We've got a variety of initiatives in that area. We're always asked those questions, so I'll point out a couple of things. Of course, a year and a half ago, we replatformed the site, and shortly thereafter, added mobile apps.

We've combined, in the last year, some ecommerce merchandising efforts, within line efforts. We think that's given us a better merchandise capability there. We've added a few categories, most particularly apparel, some apparel items. And we've done, I think, a better job of improving the timing of shipments by expanding the various shipping points, getting merchandise more quickly to our members.

In terms of expansion, last year we opened 26 units and started fiscal '13 a quarter ago at 608 units and ended at 634. So it was up a lot of 4% square footage growth. This year, assuming we get to the 30 net units, on a base of 634 that would round up to about 5% square footage growth. Now, again, if we get to 30, and we expect to, 16 in the U.S., 4 in Australia, 3 in Canada, 2 each in Korea, Japan, and Spain, and one in Mexico.

Square footage at Q1 end totaled 92,654,000 square feet.

With that, I'll turn it back to the operator for Q&A, and I'll put myself on speaker phone here.

Question-and-Answer Session

Operator

[Operator instructions.] Your first question comes from the line of John Heinbockel with Guggenheim Securities.

John Heinbockel - Guggenheim Securities

On gross margin by category, can you give a little color? Two were up, two were down. I know mix might be some of the explanation, say hardline's up maybe because majors and TVs down. But a little more color on that, and are there clear areas where you're making some price investments in that grouping of four?

Richard Galanti

Clearly fresh foods is the one I've talked about in the past. Fresh food margins year over year in the quarter were down. Frankly, they were down, I think, less. In Q4 it was a bigger down year over year. There are a lot of moving parts, of course, but when I go to the budget meeting each month and hear the merchants talk, certainly fresh foods is an important part. As we go into the seasonal period of September through December, you're trying to do some hot prices on exciting nonfood items as well, bigger ticket items.

TVs, in my view, has a little bit more to do with SG&A. When you sell a few less thousand dollar price point items, that probably impacts your SG&A a little bit. But I don't even know how much it moves the needle. It helps, but it's one of many things.

So we keep doing what we're doing. I don't think there's any big surprises to us in these numbers. If anything, one of the things I mentioned last quarter, when I pointed out fresh foods were, I think, 80 or so basis points lower year over year, and it's quite a bit less than that delta in the first quarter, part of that was, as we'd maintained some key prices on some very high volume key items like the rotisserie chickens, as some of the underlying costs come down a little from their peak, that helps margin a little bit.

So I think we haven't changed what we do necessarily to try to reduce that delta or prove a positive delta, it's just where it came out. We're ever diligent in being competitive out there.

John Heinbockel - Guggenheim Securities

Do you think longer term, over a five to ten year time horizon, that as Kirkland penetration goes up, do you think that gives you much room to get sharper on branded pricing? Or not really excited about, that's an independent decision?

Richard Galanti

Honestly, there's a hundred different independent decisions. That's part of it, certainly. When we expand Kirkland Signature, it does a lot of things. In many cases, as you suggested, we can get a little bit more margin and provide even greater value to our member.

As important, in some cases it drives a lower price on the branded item as the branded item loses market share to the private label, which again serves us and our member well. So overall, on an overall basis, probably increasing penetration of KS helps you. I think increasing penetration of our total sales in locations that don't have a direct warehouse club competitor helps you a little bit in some of these other countries.

As you can see from our segment analysis, certainly it would imply that in Canada, which again has been a very strong economy and good growth for us locally as well, not having a direct warehouse club probably works a little higher margin. Not a lot. I mean, we don't take great advantage of that.

John Heinbockel - Guggenheim Securities

And in terms of expansion, I know every country will have different levels of capacity peoplewise, but when you sort of aggregate it, is there a level - you know, as you do 30 this year, maybe a couple more next year - is there a level where you simply, for people reasons, cannot go beyond that without fearing execution might slip?

Richard Galanti

For us, long term is two or three years sometimes. I think five years ago, when we were averaging something in the low 20s, our goal was to see, you know, can we get it up to 30. And we feel pretty comfortable, as I indicated in the last few calls, that both this year and over the next three or four years some number in the low to mid 30s we feel pretty good about, hopefully starting at 30 and ending at 35 in a few years.

Beyond that, one would think that we could expand that a little bit if the opportunities still present themselves out there. I don't think that will be a people issue. We've done, as you know, a lot of ramp up in several countries. We've gone from 8 to 18, or 9 to 18 units in Japan in the last couple of years. We're going to go from 3 to 7 or 8 in Australia this year. And we're adding as fast as we can, it's harder to do in Taiwan and Korea getting sites, but we've got the pipeline full, so hopefully we'll get a little more there.

And so that strains you a little bit, because you don't want to move some of those people. If anything, we've devoted more people to those areas. But I don't think that's a constraint. I mean, if we did 25 a year four or five years ago, and we're doing 30-ish plus a year now, and five years from now certainly something north of that, assuming the opportunities out there present themselves is certainly a likelihood.

Operator

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

Paul Trussell - Deutsche Bank

If we kind of strip out the impact of gas, could you just speak more to operating margin performance this quarter in the various segments between U.S. versus Canada and international?

Richard Galanti

I think the detail will be in the Q. I don't think there's any big trend changes from most recent year and quarters. In terms of operating profitability as a percentage of sales, Canada is stronger than the U.S. It has had a great economy, it's been a great business for us. It has no direct warehouse operator. Its healthcare costs, on average, are a little lower. So all those things worked in our favor.

The other column, it generally is more profitable, but again we're opening a lot of new units, and we're cannibalizing. Going into Spain, we'll certainly have not only a little extra preopening, but once we get open, $0.5 a million or $1 million a month just in central over there, with one partial unit for a few months.

So I think those things tend to make that column a little harder to understand, and generally speaking, many of those countries in that other column tend to be higher pretax percent of sales than the U.S.

Paul Trussell - Deutsche Bank

And then just moving to the U.S., can you just give us an update on the top line trends that you're seeing in California?

Richard Galanti

No big differences. The big differences in California were way back when the economy first got hit. Not only California, but Arizona, Las Vegas, and Florida, if I recall correctly. Those were the ones that were hit hardest.

I think California overall is probably a shade lower than the rest of the U.S. But the rest of the U.S. includes, you know, Midwest, Texas, where we're opening new units, and we've been pretty successful in seeing more robust top line sales growth.

Paul Trussell - Deutsche Bank

And just my last question, can you just remind us and give us, on the expense side, how should we think about some of these investments that you're making and the impact over the next few quarters?

Richard Galanti

The one that I pointed out now, for probably the last five fiscal quarters, all the quarters last year plus this first quarter, is IT modernization. We have finally had the courage, I think, a few years ago, to recognize that we had great home-grown systems that were kept together and allowed us to do what we wanted to do, but as we're becoming more global, and bigger, and getting to a platform and a whole IT infrastructure, that will serve us as we go from hopefully $100 billion to $200 billion in the next many years.

That's several hundreds of millions of dollars over three or four years. We're halfway into it, maybe a little under halfway into it, and so my guess is I'll be talking to you about a few basis points each quarter year over year and incrementally probably into '15, before it starts flattening out and coming down.

But not only is a lot of that expenditure necessary, there's dividends, we believe, that will come from it too. In a way, one of the first modernization things we did, even before we called it modernization, was replatforming dotcom a year and a half ago. Again, we had a website, the search engines couldn't even crawl on it, to give you a simple example. We see the potential there. Still relatively small business to our company, but a very profitable business, so we think there's a lot of opportunity as we replatform and we rewrite the membership system, the basic buying systems, the [unintelligible] systems. But it's necessary as well.

Beyond that, it doesn't seem like healthcare costs are going to change dramatically in the U.S. As a higher percentage of our total company is from overseas, outside the U.S., for the most part every other country that we operate in, the healthcare related costs are lower as a percentage of sales. I might be wrong on one country, but for the most part that's correct.

So those are the kinds of things that, again, there's probably a few structural things that, as non-U.S. sales become a higher percentage of the total company, whether it's a lack of direct warehouse competition in many of these countries, whether it's lower healthcare costs as a percentage of sales, in some cases a little higher membership fee percentages as a percentage of sales, maybe in some cases occupancy as a percentage of sales is a little higher, but more than offset by the other things I mentioned. So generally speaking, I think that will tend to help us a little bit, and I try to point that out as we go along here.

Operator

Your next question comes from the line of Meredith Adler from Barclays.

Meredith Adler - Barclays Capital

You're talking about international, and you're going to be opening up a couple of clubs in Spain. Can you talk a little bit about what your strategy is about Europe, and the reason for Spain, and not for France or Italy? Just wondering how you think about that.

Richard Galanti

We've talked about Spain and France with Spain coming first and France hopefully the following year. So we have a few people on the ground in France, or less than a few. But we're working towards that. And you know, when we looked at where are we going to go before we decided on those two, there's various different parts of the world, we felt that we've had a place of operations in the U.K. for many years, under a little different format, in terms of how we market to our Gold Star members in the U.K.

But we always looked at Western Europe as a good opportunity for us. Frankly, the economies over there we feel have allowed us the opportunity to get in and to be welcome. We provide good, high-paying jobs, we're great competitors, and frankly we see the economy a little better than some of the numbers you just read about unemployment. So we think it was an opportunity for us to get in when historically it was a little harder, and we'll see where we go from there. But to start with, it will be Spain first, France second, and then we'll let you know when we do.

Meredith Adler - Barclays Capital

And is it fair to say that you are looking at places where people are looking for those unique values? So Germany, where the economy has been stronger, they would be something that would come lower on the list of priorities?

Richard Galanti

Well, we do better in stronger economies, frankly. I think each country has its own set of challenges compared to the United States. And again, I'm not prepared to talk a lot about some of those other countries at this point, since we're focused right now on really ramping up the newer countries, like Asia and Australia, as well as what we're doing in these new two countries over in Europe.

Meredith Adler - Barclays Capital

And then I have a question about ecommerce. First, I was just wondering, I'm sure you do talk to your members, what kind of feedback do you get from them about how much they want ecommerce to be part of what they get from Costco? And is it discussions with them that have a big influence on what you actually sell online? Or are you trying to test new things or sort of branch out in any way through ecommerce?

Richard Galanti

We take member comments all the time, both online and in warehouse. Ecommerce is certainly an important component of what's out there, what's growing. We recognize we're a retail competitor. It's part of the landscape. We're very much a brick and mortar. You know, 97% plus of our business is in store, not online. What we have done is we looked at it as not trying to offer a million different items for our members. Arguably, we don't offer a million different items to them in store. We offer less than 4,000.

And we view it as an extension of that, in some categories, as well as some overlap. We've been successful in bigger ticket items, hard to handle items like furniture and televisions. But I think the example I mentioned earlier about apparel, we tried some apparel items several years ago in online, and underwhelmed us and our members. We're trying some different things now, and it seems to be working.

But again, ecommerce is a small percent, and a given department like that is a small percent. But we are getting some traction. We want our members to buy everything at Costco, whether it's in-store or online, and we'll keep trying some new things.

Operator

Your next question comes from the line of Michael Montani from ISI Group.

Michael Montani - ISI Group

Wanted to ask about inflation. It looks like maybe with gasoline in total it could have been slightly down for this quarter. Is that right? And also, what are your buyers seeing out there six, nine months out?

Richard Galanti

Again, we had a very small LIFO charge. Given the volatility in gas, it was deflationary, although I don't think we took any of that in the first quarter. We tend to wait into the year. That's what we've done over the past many years. So probably, including gas, yes, it was slightly deflationary, but not reflected in our small LIFO charge.

In terms of outlook, the only thing that I can recall from the budget meetings has to do with some fresh food items or commodities. You know, three months ago, the outlook was three to six months hence, so that would now be three months. Generally speaking, I think that's still the case, with the exception of some produce items which are more a function of what's going on with weather in different places. I know there's been shortages in berries and each of these items are big volumes for us, and that drives the price and availability of these things up.

But overall, I haven't heard about, from the general nonfood areas, anything big. If I look at the last month, just strolling down the 30 biggest inflationary items, there's a few on the beef side, there's several produce, like strawberries is up 25% plus, blueberries up more than that on a cost basis. Then I look on the deflationary side, you have the usual suspects of electronics and gas, of course, as I mentioned earlier. And a few other items that generally are some commodity items that peaked a year ago and come down some. So again, no big inflation raiser this time.

Michael Montani - ISI Group

And just a quick follow up on Kirkland. Can you just remind us where the penetration is today, and is it still kind of 50-75 type penetration increases that you're seeing?

Richard Galanti

It's in the 23 plus range. My guess is it's half a percent. Part of that is that as we roll out gas in Canada, aside from gas deflation right now, as gas from the company has gone from 9 to 10 to 11 to 12 percent, everything else, KS, is increasing relative to that other 87 or 88 percent.

Michael Montani - ISI Group

And then just an ecommerce question, actually, that has somewhat of two parts. If you bear with me, the first part is can you just talk about some of the efforts that you have to sort of integrate your work online with the in store experience, and how there's interplay there? And then the second one is the AP to inventory ration this quarter obviously came down a little bit.

When we look at one of your larger competitors in Amazon, it's north of 200. So I'm just wondering if there's opportunity for initiatives there to really increase that, and if we'll hear about you guys cohabitating, so to speak, on warehouses with some vendors or anything like that.

Richard Galanti

First of all, as it relates to Amazon's enviable 200 basis point, I think a lot of that, as I understand it, for every dollar of reported sales they've got close to $0.50 of other throughput, which is not a sale. It doesn't report on their GAAP income statement, because they're handling merchandise for others, where they charge service fees for doing that.

In many instances, when that merchandise is sold, it's sold through Amazon and Amazon gets the money and doesn't pay those third-party sellers, if you will, until after. And so my understanding is, and I could be wrong, a big chunk of it is that. I would assume, as they handle more inventory that are their sales, that will pressure that number a little bit, but that's a very enviable number to have.

In our case, on the other hand, we've always kind of looked and said, how can we get to 100%? Can we get no cash required for our inventories? It's going to fluctuate. This one downturn here has more to do with Thanksgiving than anything. That one week, burning a couple of extra days of sales or incremental equivalents of a day of sales, we get that back in order pretty quickly.

I think that as we're ramping up expansion, that will tend to reduce the number a little bit. But we've always been in the high 80s to very low 100s, depending on which fiscal quarter and timing it is. And I don't see a lot of change there. Ultimately, if we can turn our inventory faster, it's going to help that. Gas has helped it in a perverse way. We turn our gas many times a week, many, many times a year. So we've got a lot of payables there relative to inventory.

So I think that it's going to fluctuate a little bit. The only think I wanted to point out in this quarter was Thanksgiving had more to do with the reduction there. I think our inventory turns, our goal is to continue to turn it faster. Ecommerce turns it faster for sure for us, but it's 2.5% of our business.

Operator

Your next question comes from the line of Matt Fassler with Goldman Sachs.

Matthew Fassler - Goldman Sachs

We were hoping you could comment on the buybacks. Specifically, did you guys do any this quarter? And if so, how many shares did you repurchase?

Richard Galanti

We did not do any this quarter, but stay tuned.

Matthew Fassler - Goldman Sachs

And then just a clarifying item on the stock expense. I guess you mentioned that some of the increase year on year was related to, basically, it was more [tenure]. Is that a trend that continues here going forward? And would you expect additional pressure on that line because of it?

Richard Galanti

That will continue to have some pressure, recognizing every time a given person hits 25, 30, or in a very few examples 35, that’s going to hit it, although that reduces that amount because it’s the same charge over five years, it just comes sooner. And so it will be bumpy sometimes. When I looked at the four quarters this coming fiscal year, the big hit is in Q1. It dips a little bit in Q2. It dips back up in Q3, and dips a lot in Q4, relative to the increase we saw in Q1. Some of that has to do with the timing of acceleration.

In addition, we’ve always put a lot of compensation focus in most of those people’s cases, or in many of the managers and above, if you will, over half of their annual compensation relates to stock, and hopefully stock price performance.

But we’ve tended to try to keep the number of grants each year to a given person at a given responsibility level the same. This is the first time in many years that we’ve reduced it, recognizing the stock has been very strong, not only this year but several years.

Now, again, by reducing the grant by an average of around 15% per recipient - and it ranged from zero for lower grants to 20% for our CEO and chairman and board - that will continue to impact us for a few years year, but I think this was a little bit more of an anomaly this quarter and it will be an anomaly in the third quarter and sometimes there will be a little less. But overall, I think it will be a slight increase of the SG&A in each of the next couple of years.

Now, one thing that will reduce it if the stock, next October, is at a price lower than the $117 or $118, but we hope that goes the other way and it’s a little higher expense, so we’ll see.

Operator

Your next question comes from the line of Jason DeRise from UBS.

Jason DeRise - UBS

I always get a lot of questions about why you do so well internationally. And so I was wondering if we could get some color on a few specific markets, particularly in Canada and Mexico. And I guess I'm talking about just top line success, and if you can comment at all about how you're doing with members there?

Richard Galanti

Canada, first of all, has had a great local economy. It didn't get hit with the financial crisis that we in the U.S. did. Some of its economy is natural resource based, which has been on a boom for the last couple of years.

Jason DeRise - UBS

But there's more competition in Canada too, and when I look at some of your competitors there, it doesn't sound so rosy, so it's got to be something else.

Richard Galanti

Well, there's no direct competition, there's no other warehouse club operator. Mind you, our warehouse club business is roughly at 11% gross margin. Other forms of big box discount ranges everywhere from the very high teens to, in the case of home improvement, to the low to mid 30s. But call it the high teens and low 20s for general merchandise big box discount. And supermarkets, of course, are in the mid-20s and up.

So at 10 or 11, that's a pretty compelling value proposition, when you don't have another warehouse operator. So I think that helps us a little bit. We don't take a lot of advantage of that. We have a little extra margins. In some countries, while our labor cost in every country we view our labor wage rates are at a significant premium to comparable big box hourly retail, they frankly are lower in terms of dollars in some countries. And sometimes the top line purchasing power is not as low. So that helps your percentages there.

And some countries, like Asia, we have a lot more members per warehouse when we start up, so we have a little higher percentage of membership fees as a percentage of sales. Again, on a macro basis, the one thing internationally in some of these countries that stands out a little higher might be occupancy, but we own 80% of our units, so you don't see that in SG&A, frankly, a lot. You see a little more depreciation perhaps, but you don't see rent charges.

And so all those things have tended to help, but by and large, in my view the big factor is going to be no direct warehouse competitor.

Jason DeRise - UBS

And then in Mexico, I guess that's one that's every monthly sales call it's been called out as one of the strengths, and we haven't seen that many openings from you. You do have a direct competitor there, so maybe talk about what's working in Mexico.

Richard Galanti

Well, it's working very well for us. We have, I think, 33 or 34 units. Sam's has over 100. They have been much more aggressive over the years. We know saleswise that our units, like the U.S., do more volume per warehouse.

Until July of 2012, we owned 50% of a venture, and operated it, with a very good partner, Comercial Mexicana, down there. They had some financial issues, and so for I think five years, leading up to July 12, over five years we opened a total of two units down there. We have ramped up our activities and efforts down there. We opened, I think, one this year, but we've got plans for more.

And you'll see that come up a little bit. We're not going to go crazy. We're not going to go from 30 to 40 in a year, but you'll see that 0.4 number, if you will, two units over five years, increase quite a bit and continue in that direction.

Jason DeRise - UBS

And just one more question about some of the new markets. As you thought about Australia, and I guess now Spain, do you think it's more like a Canadian market, where if you keep your margin structure, in terms of your markups, the same as the U.S. or any other market you compete in, that you think you just come in at a wider gap, and that's why you picked it, those markets, as the next of the evolution? Or is there something else about where you can source product that you're bringing back to the U.S.? I guess there's some less known synergy about shipping to Asia crates of American product and bringing product back that you're selling in the U.S.

Richard Galanti

I like to think we're that smart sometimes. But again, we look at all countries around the world, and where we're going to go. Australia we viewed, much like we did Alaska and Hawaii 25 years ago, where the margins, and the markups, in those two states were dramatically different than the mainland. And Australia also has a very high price structure.

As I understand, two retail competitors have upwards of two-thirds of the market share over there. So we came in with our margins, which were even more dramatic over there. But we also look at it as what is the potential.

Part of our due diligence, if you will, in addition to looking at various metrics like population and small business and average household income, is really shopping the towns, and going over and visiting these places, you know, feet on the ground, all the way from our chairman and CEO to key merchants and operators, and see how vibrant the retail business, and how competitive it is. We think that as we've gone into these countries, clearly we are the extreme value proposition in terms of markup.

Again, when we look at Spain, we think the economy is a little better than some of the numbers would portray in terms of unemployment. But we're there for the long term also, and the economy should get better over time. But it's less to do with what products come from there.

Part of our success, as an example, in Asia and these other countries, is bringing not only Kirkland Signature items but in some cases U.S. sourced goods that aren't there. And we all think of ourselves sometimes as liking things like Italian leather and cashmere from Europe, and guess what, some of these other countries like big American stuff at great value and prices. So that's helped us as well.

Operator

Your next question comes from the line of Chuck Cerankosky from Northcoast Research.

Chuck Cerankosky - Northcoast Research

I'd like to focus on the second quarter to date, and how has the sales cadence been trending by week, and how do you feel about the mix thus far as the second quarter has progressed towards Christmas?

Richard Galanti

Of course, we don't provide any guidance. Nice try. The only thing we did say, certainly for everybody, not just us, in the U.S., the switch of Thanksgiving a week later certainly impacted November reported sales and the November-ish month of our first quarter. The fact that there's five less days between Thanksgiving and Christmas, less selling days, that's certainly going to be an impact for everybody out there. But you know, we plan for it.

Operator

Your next question comes from the line of Scott Mushkin from Wolfe Research.

Scott Mushkin - Wolfe Research

Just following up on Chuck's question, and kind of getting your take on the sales climate, aside from the one less week that you talked about, a number of companies have seen their sales slow post-Labor Day, and you guys have been somewhat immune to the slowdown, although that did change a little in November. Was that due in part to the one less week, as you just mentioned, or is there anything else going on that you could comment on?

Richard Galanti

There's not a whole lot we see. Not really. We've commented on the slower TV sales. It was very strong a year ago. I think there's a little less promotion out there. But there's really not a whole lot beyond that. Frequency continues to be strong.

Scott Mushkin - Wolfe Research

And then just following up on that, it sounded like last quarter, if my memory serves correctly, that you'd be willing to keep some margin if prices fell more quickly, as you maintain your competitive pricing in areas such as food. Has anything changed in the competitive landscape over the last couple of months, or what you see over the next few months that could mitigate your ability to capture some of that margin if it's available?

Richard Galanti

First of all, separate sales and margin. We don't really see a whole lot of change in the landscape, other than a few retailers opened earlier into Thanksgiving this year. We don't really see a whole lot out there different. There's certainly more promotional stuff that we all read about each day that some of the power retailers are doing, and [onto the] merchants.

Operator

Your next question comes from the line of Charles Grom from Sterne Agee.

Charles Grom - Sterne Agee

Just a quick follow up on an earlier question. You guys mentioned no buybacks in the quarter, and haven't had any since Q1 '13 it looks like. Could you just maybe talk a little bit about the strategy to return cash to shareholders with regard to the various vehicles that are available to you, whether it be another special dividend or increasing the ongoing dividend, or starting to buy back more shares aggressively going forward?

Richard Galanti

Well, again, it's more art form than science here. We still view our outlook and our opportunities going forward positively. First and foremost is to ramp up expansion, which we have done, although we're generating more cash than that. We have historically, for now eight or nine years, raised our dividend every spring, I believe. We of course did a big special cash dividend, a little over $3 billion, last December.

And I think you'll see all of the above. We haven't looked beyond where we are now. We're not sitting around looking at special dividends as an example. I'm sure next spring the board will consider what they want to do with the regular dividend, and again, I don't want to be coy, but we'll continue to look at stock buybacks and let you know next quarter what we did or didn't do. But we view all those vehicles as logical vehicles for us going forward.

Charles Grom - Sterne Agee

And then just wondering if you could perhaps provide some perspective on the U.S. consumer right now. The general retail environment seems to be more promotional this holiday season, while your approach has always kind of been more in terms of offering everyday value. So I'm just wondering what you're seeing out of the consumer in terms of his or her appetite for even more competitive pricing, and do you think the generally more promotional environment is affecting your business at all materially?

Richard Galanti

We do not think it's affecting us materially. I mean, the fact is that when there's a lot of promotions, they work. If some traditional merchants are backed up in inventory, they're going to be very much more promotional. I think as evidenced by our frequency, we still have them coming in, and we have them coming in a surprisingly continued increase year over year.

Now, that being said, if they stopped at these promotions first, that's one less thing they may buy at Costco. But we feel very good about our merchandising and our own merchandise marketing activities as it relates to the MBM, some hot buys. We think that we've got a lot of good things going on. Again, in talking to the senior merchants, we feel quite good about coming out of the season with nothing unusual in terms of markdowns and having clean inventory. So I think that's, in my view, good evidence that we're not seeing a big impact out there.

Charles Grom - Sterne Agee

And then just one more, if I may. Can you provide an update, and maybe some flavor, on the progress of some of your newer merchandising initiatives, whether it be in organics or upscaling of fresh foods and cosmetics, or improved assortment in apparel? Any color there would be appreciated.

Richard Galanti

I think you mentioned two or three of the ones that would be at the top of the list. Certainly we've talked about apparel now for a year, year and a half, and having still double digit increases year over year, two years out. Part of that is our own commitment to expanded apparel. Part of that is from brands. Part of that is the Kirkland Signature. We've got a great Italian wool men's pant that's $49, actually $39 right now, and we've gone from 100,000 to 1 million pair in the last few years. We're massing that up better.

Cosmetics, we've got a couple of units in the L.A. market where we're testing some expanded cosmetics. We still would like to get more brands to sell us, but we're pretty scrappy, we're getting a few things in ourselves. But it's still a small business for us.

The ticket programs, whether it's for movies or for ski vacations or local restaurants, those continue to grow. So again, probably one good thing over the last year or so is some of these nonfood categories, from apparel to domestics to housewares. Those have had some good legs for us.

Operator

Your next question comes from the line of Michael Exstein from Credit Suisse.

Michael Exstein - Credit Suisse

Thank you for the update on ecommerce. Could we sort of shift to another part of ecommerce? Amazon announced today that they're going to start home delivery of grocery in the Bay Area. Where are you in sort of thinking about what you do with the grocery business as new threats come into it, and how do you look at that new form of competition?

Richard Galanti

We'll keep looking at it. We have no plans currently to deliver to homes anything other than through ecommerce, which tends to be nonfood items, and very limited foodstuffs, and surely not fresh foods. We enjoy watching the landscape as others are getting into those types of businesses. Some of the supermarket chains, Walmart.

You know, Google is doing something in the Bay Area as a test with a number of brick and mortar retailers, including us, where they'll deliver through the Google Mall. They come in and buy it. We do some help in store at just a couple of locations, as a test, but it's small, and it's a test.

So I think there's going to be a lot of changes over time. You know, getting overnight delivery or same-day delivery is great, but ultimately you've got to pay for it, and we'll see. I think there's probably a market for it, but we'll see how big that market is. We keep doing what we're doing in terms of value. If things change dramatically out there, we'll figure it out, but there's a long way to go there first.

Michael Exstein - Credit Suisse

Has your business in grocery in Seattle, where Amazon has been most established, been any different overall than elsewhere in the country?

Richard Galanti

No.

Operator

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

Peter Benedict - Robert W. Baird

Just wanted to follow up on Michael's question there, on the online business. Clearly you guys have a lot of good momentum here. In terms of just fulfillment as it relates to online orders, it sounds like you guys aren't interested in delivering to homes. But just curious where you stand in terms of developing capabilities such as buy online, pick up in store. Is that something we should expect within the next few years? Or are these types of flexibility fulfillment capabilities just not really important to your core customer?

Richard Galanti

Well, a lot of what online is is delivering to home, but it's delivering televisions and swing sets and furniture and some apparel, again, a very limited amount of shelf stable, if you will, food items. And then we also do office products and things online to small business.

But you know, look, 97.5% of our business is in store. It's continuing to grow nicely. People actually do like to go out and shop. And when I've been asked the question before, on Amazon Fresh, up here in Seattle, or some other type of fresh delivery in other parts of the country, in New York, what have you, my sense is that probably that's taking some market share more from what are the other daily or every other day alternatives when you're stopping at the supermarket two and a half, three times a week? Again, on an incremental basis, is there something you're going to get that way that you didn't get at Costco?

But if we can keep you coming in, you're still getting a lot of key bulk items at our place on the fresh food side as well. And our most loyal members are still getting some of those things at supermarkets and other forms of convenience. And Amazon will be just one of those, or other forms of overnight or other delivery.

You know, it's different value. Again, we recognize convenience is a value. I think both Amazon and some of these others out there, the quality tends to be good, the availability sometimes is good or not, but you're paying for that convenience, and there's a lot of things that people are still going to buy at our place, and if we can keep you coming in, then we'll get our share of that.

Peter Benedict - Robert W. Baird

And just a question on traffic. I think you said up 4.5% in the quarter. It's been pretty consistently healthy. Is there any material difference you guys are seeing between U.S. frequency versus the trend internationally?

Richard Galanti

It's pretty much the same. It's a little higher in new markets. If you asked me what's the most surprising, it's that the U.S. is pretty darn close to the rest of the world. Canada is a little higher than that, and again, as evidenced by a local currency comp in the mid to high singles.

And by the way, some of the frequency numbers change. Like, as we cannibalize, as we go in two years from roughly 9 to 18 units in Japan and add 2 or 3 more units in Tokyo, that's going to cannibalize and reduce the frequency of that existing unit.

Operator

Your final question comes from the line of Budd Bugatch with Raymond James and Associates.

Budd Bugatch - Raymond James

My questions kind of go back to international, and I'm curious if you could shed some light on what other countries similar to Spain exhibit attractive characteristics that you may look to get into in the future?

Richard Galanti

It will be a while, and if I knew, I wouldn't tell you. [laughter]

Budd Bugatch - Raymond James

So moving on to my follow up, where do you see the international business going as a percentage of total sales eventually, and the exposure to currency fluctuations as a result?

Richard Galanti

Well, I think it's going to continue to increase. Five years ago, 80% of our unit openings were in the U.S., or 75%. This year 50-55% will be U.S. Over the next three or four years, probably a shade under 50, maybe 40-45% perhaps. So I think over time it will continue to increase.

I think the U.S. will still be above 50%. It's now around 70%, low 70s. But that will change over time, and again, the relative profitability of these other countries tends to be a little higher than the U.S., so the profitability penetration will probably get there a little earlier.

And in terms of currencies, arguably we tend to have a currency in the U.S. that on average tends to be stronger over long periods of time than others. So that will impact us, but we'll let you know what that impact is. That will be part of our makeup.

Operator

There are no further audio questions.

Richard Galanti

Thank you, everyone. Have a good day.