Costco Wholesale Corporation (NASDAQ:COST) Q1 2016 Results Earnings Conference Call December 9, 2015 11:00 AM ET

Executives

Richard Galanti – EVP, Chief Financial Officer

Analysts

Charles Grom - Sterne, Agee & Leach

John Heinbockel - Guggenheim Securities LLC

Simeon Gutman - Morgan Stanley

Michael Lasser - UBS

Robert Holmes - Bank of America Merrill Lynch

Christopher Horvers - JP Morgan

Paul Trussell - Deutsche Bank Research

Brian Nagel - Oppenheimer & Co.

Matthew Fassler - Goldman Sachs & Co

Steven Zaccone - Cowen and Company

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Meredith Adler - Barclays Capital

Chuck Cerankosky - Northcoast Research

Scott Mushkin - Wolfe Research

Robert Drbul - Nomura Securities

Daniel Binder - Jefferies & Co.

Operator

Good morning. My name is Brandy and I will be your conference operator today. At this time, I would like to welcome everyone to the Q1 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speaker's remarks, there will be a question-and-answer session. [Operator Instructions]

Mr. Richard Galanti, CFO, sir, you may begin your conference.

Richard Galanti

Thank you, Brandy, and good morning to everyone. This morning's press release reviews our first quarter of fiscal 2016 operating results for the 12-weeks ended November 22.

Before I begin, please note that these discussions will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements address risks and uncertainties that may cause actual events, results and/or performance to differ materially from those indicated by such statements.

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

To begin with our 12-week first quarter of fiscal 2016, for the quarter, our reported earnings per share came in at $1.09, $0.03 below last year's reported figure of $1.12. There are several items of note, six to be exact, that impacted this year over year comparison of Q1 earnings.

First, FX in the first quarter, the foreign currencies where we operate were weaker year over year versus the US dollar, primarily in Canada, Mexico and Korea, such that foreign earnings in Q1 when converted into US dollars for reporting purposes were lower by approximately $42 million, or $0.10 a share, than those earnings would have been had FX exchange rates been flat year over year.

The big weaknesses started about a year ago, while I certainly don't know what's going to happen tomorrow and there's been continued weakness, certainly the biggest impacts looks like the last four quarters. One of the benefits, of course, is purchasing land and building units in some of these countries was little cheaper over the last year.

Number two, stock compensation expense was $36 million higher year over year in the first quarter or $0.05 a share. We have over 4,600 people who receive restricted stock units. For many of them, it is a significant part of their annual compensation. These grants are made annually each October in our fiscal first quarter.

While these grants typically vest over a five-year period, accelerated vesting occurs when a recipient reaches 25, 30 and 35 years of employment with the company. So factors driving this $36 million increase included additional levels of accelerated vesting given the rising number of employees achieving long tenure with the company. This, by the way, is most impactful each Q1, given our October RSU grant cycle.

Two, appreciation in our stock price and of course the larger number of employees in the plants. I'd like to note that because of the significant price appreciation in our stock this past year, this year's annual RSU grant, which occurred in late October, was reduced by an average of 12%. That is the number of RSUs granted to each recipient.

So while there was a $36 million year over year increase in Q1, in the upcoming second, third and fourth quarters of this fiscal year, the anticipated year over year increases are estimated to be about a third of this dollar amount in each of the fiscal quarters. So $0.01 to $0.02 earnings year over year impact each quarter in second, third and fourth quarters versus the $0.05 a share impact in Q1.

Third point I'd like to note, there are two SG&A items that together negatively impacted this year's Q1 earnings. In the first quarter, we recorded a $22 million charge related to two non-recurring legal and regulatory matters. The $22 million figure represented an 8 basis point to SG&A and impacted our first quarter earnings per share by $0.04.

Point number four, IT modernization, as discussed in each of the past many quarters over a couple of years now, our major IT modernization efforts continue to impact our SG&A expense percentages, especially as 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 an estimated $20 million pre-tax, or 7 basis points, 6 basis points without gas deflation which is about $0.03 hit to earnings in the quarter versus last year.

Point number five, last year in the first quarter, we did call out that we had a $17 million benefit to gross margin related to a non-recurring legal settlement. So that benefited last year's first quarter by $0.03 a share.

And lastly, point number six, our cobranded credit card transition in the US. As you know, when we transition into a new cobranded credit card relationship in the US next year, as we wind down our current relationship, new cobrand signups have greatly slowed and in fact are for now ceased. The short term negative impact related to moneys we earn for new cobrand signups.

Year over year in Q1, this represented a $15 million or $0.02 per share hit to our earnings. This will continue to be a small negative impact to earnings in Q2 and Q3 and possibly into Q4 based on timing, at which time I'll be able to better outline how the new relationships should directionally impact our future results and the future rewards to our members under the new cobranded credit card program.

I look forward to sharing more information at that time. So six items of note, adding it up, it's about $0.27 of impact to our year over year earnings comparison. I know many of these things you may have in your numbers; I know some of them you don't.

Turning to our first quarter sales, in terms of sales for the quarter, our 12-week reported comp sales figure for Q1 showed a minus 1% decrease, plus 2% in the US, minus 9% in Canada and minus 5% in other international. As we stated in our release, if you take out the two big impacts of gas price deflation year over year and the impact of negative FX, the plus 2% reported US comp would have been a plus 6% in the first quarter, the minus 9% in Canada would have been a plus 9% and the minus 5% other international would have been a plus 7%, such that the minus 1% reported comp would have been a plus 6%.

And as we reported last Wednesday in our November sales results for the 4-week month ended November 29, our comp sales increase excluding the impact of FX and gas was similar to the 12-week first fiscal quarter, with total company comp increase of 6% and again ex gas and FX in the US of plus 6%, in Canada a plus 8%, in other international a plus 7%.

In terms of opening activities and plans, we opened 13 new locations in Q1, including two relos, for a net of 11 new warehouses during the quarter which ended November 22. That included seven in the US, one in Canada, one in Australia our 8th in that country, one in Japan, our 24th in Japan, and our second in Spain, just outside of Madrid, in Getafe. That's our second unit in Spain. Two relocations were in Woodland Hills, California and Teterboro, New Jersey.

In the second quarter, we had two new business centers planned to open, one each in Westminster, California and in Hackensack, New Jersey. And for all of fiscal 2016, we have a current plan to open up 32 net new locations. That could come down a little bit based on timing as we get into the second half of the year, a few may be delayed, but that's our current plan. Of those, assuming we're able to do all 32, 22 of them would be in the US, three in

Canada, two each in Japan and Australia, and one each in the UK, Taiwan and Spain.

Later in the call, I'll review with you our e-commerce activities, our membership trends, additional discussion about gross margin and SG&A in Q1 and recent stock purchase activities.

Again, very briefly, sales for the quarter in reported were up 1.3% to $26.6 billion, up from $26.3 billion a year ago. Again, on a comp basis, reported number was down 1%, but ex gas and FX was up 6%. For the quarter, our minus 1% reported comp sales results were a combination of an average transaction size down 4% for the quarter. Again, taking out gas and FX, it would be up 3% excluding those items and an average shopping frequency of about 3.5% for the quarter.

In terms of sales comparison by geography, geographically for Q1, the better operating performing regions in the US were all three regions in California and the Midwest as well. Internationally, in local currencies, the better performing countries were Australia, Taiwan, Mexico and Canada.

In terms of merchandise categories for the quarter, during the quarter, which we look at September, October and November, excluding FX and gas, within food and sundries, which were up in the mid single digits year over year, sundries, [meat] [ph] deli and spirits were the relative standouts.

Our hard lines sales were up in the mid to high single digits for the quarter. Majors are electronics came in positive first quarter in the low double digit range. In addition to electronics, better performing departments included hardware and garden and patio. Within the mid single digit soft line comps, domestics, women's apparel and home furnishings were standouts. And in fresh foods where our comp sales were in the mid to high single digits, produce was at the top of the four sub-categories.

Moving down to line items on the income statement, membership fees, in the first quarter membership fees were up 2% – 2 basis points up $11 million, coming in at $593 million versus $582 million a year ago. Again without FX, the dollars would have been up 6%.

I noticed in several of the preliminary notes from some of the sell-side analysts out there, they had expressed some questions about the strength in membership and I might point out a couple of things. In addition to being up 6% ex FX, on a cash basis, there was about another percentage point higher than these numbers as well anecdotally a year ago we did a couple of things outside with social media which we didn't do, small impact year over year, but something versus nothing.

In terms of membership, we continue to benefit from good signups in existing and new locations, continued increasing penetration of our $110 a year executive membership and strong renewal rates, averaging up to 91% in the US and Canada and averaging up to 88% worldwide. Our new membership signups in Q1 year over year company-wide were up 7%.

In terms of members at Q1 end, gold star came in quarter end at 34.7 million, up from 34.0 million at year-end. Primary business, 7.2 million at quarter end versus 7.1 million a quarter ago. Business add-on remained at 3.5 million. So total memberships, 45.4 million at quarter end, up from 44.6 million and including extra cards, 82.7 million cards out there versus 81.3 million 12-weeks earlier.

At Q1 end, paid executive memberships came in at 16.4 million, which was an increase of 307,000 or 26,000 new executive members increase each week in the 12-week fiscal first quarter. As you know, executive members are over a third of our member base and over two-thirds of our sales in those countries where executive membership is available.

In terms of renewal rates, in the US and Canada, at quarter end, we were at 90.6%, rounded up to 90.6%. We rounded down to 90.5% at the end of Q1, that's the impact that I mentioned a quarter ago in Canada with having to re-signup the members with a new credit card program, a de novo program. That was a small impact. I think there was [indiscernible] in the US, perhaps based on what I said earlier. Total worldwide remained at 87.8% at quarter end and at fiscal year end.

Going down to gross margin line, our reported gross margin in the quarter was up 26 basis points, coming in at 11.29%, up from 11.03%. As you know, gas deflation is a big impact to these figures, so I'll give you a couple of numbers, I'll ask you to write down the normal four columns. For all of fiscal 2015, columns one and two would be reported and then without gas deflation and then two columns for Q1 [indiscernible] reported without gas deflation. And of course, these basis points figures are the year over year change from a year ago.

Merchandise core reported was plus 11 basis points for all of fiscal 2015, but without gas deflation was minus 12 basis points year over year. For Q1, it was plus 24 basis points and minus 3 basis points. Ancillary businesses, for the year, plus 29 basis points and plus 23 basis points. For the quarter, plus 11 basis points and plus 4 basis points. The 2% reward, minus 4 basis points and minus 2 basis points. And for the quarter, minus 3 basis points and minus 1 basis points. LIFO for all of last year was at a 5 basis point pick up both for reported and without deflation and for the quarter was plus 1 basis point and plus 1 basis point.

Other, for the whole of last year, plus 2 basis points reported and plus 1 basis point without gas deflation. And this year that nonrecurring legal settlement impacted – benefit in gross margin a year ago such that it was minus 7 basis points reported and minus 7 basis points without gas deflation.

End of those columns for all of fiscal 2015 reported gross margin was up 43 basis points, but up 15 basis points ex gas deflation. This year Q1 reported up 26 basis points, but without gas deflation minus 6 basis points, with minus 7 basis points of that minus basis points be the one-time benefit a year ago. So again, overall, those are the numbers.

In terms of the core gross margins which is the core business, food and sundries, hard lines, soft lines and fresh foods, as a percent of their own sales, they were positive year over year in Q1 by 13 basis points and they were higher year over year across all four of these merchandise categories, with both hard lines and soft lines showing stronger year over year improvement than the year over year improvement in food and sundries and fresh foods. But nonetheless, all four were positive year over year.

Ancillary and other business gross margin was up 11 on a reported basis, up 4 without gas deflation in the quarter. Many of these businesses, gas, pharmacy, food [indiscernible] all showed higher year over year gross margins as a percent of their own sales. Offsetting this a little was slightly lower e-commerce gross margins, but overall positive there.

The 2% reward was higher year over year due to higher sales penetrations for executive members. This impacted gross margin in Q1 by 3 basis points to the negative, 1 basis point to the negative ex gas. LIFO, last year at Q1, we had a $2 million credit representing slight deflation in the US inventory pools and a credit of $5 million this year, also relatively small, but in that pick up of a basis point year over year in terms of that recovery.

Lastly, I mentioned, the quarterly adjustment, a 7 basis point hit in terms of the comparison benefiting a non-recurring benefit last year versus nothing this year. So overall, gross margins excluding gas were down 6 basis points year over year, but up 1 basis point excluding that one-year charge, that non-recurring benefit from last year.

Moving on to SG&A, our SG&A percentages Q1 over Q1 were higher by 28 basis points, coming in at 10.54% this year versus 10.26% last year. But excluding gas deflation, were lower or better by 2 basis points. I'll go into some details and you'll see that the core expense components of that actually were pretty good.

So again four columns, columns one and two would be fiscal 2015 year reported and without gas deflation and then columns three and four would be Q1 2016 reported and without gas deflation. First line item, core operations, minus 6 reported and plus 16 without deflation for all of last year on a year over year basis.

In Q1, 0 and plus 26. Central, minus 7 and minus 5 for the year and minus 8 and minus 6 for the quarter. Stock compensation, minus 5 and 4 for the year and minus 12 and minus 10 for the quarter. Quarterly adjustments, nothing last year in columns one and two. This year, minus 8 and minus 8, that represents that $22 million item that I mentioned early on. So total, last year for the year over year we reported SG&A up or minus 18 basis points. And without gas deflation, better or lower, so plus 7 basis points. This year, higher by 28, so minus 28 basis points in the quarter reported and without deflation plus 2.

Within operations, again without deflation, showed plus 26 or lower by 26. Within that, our core warehouse payroll was better year over year in the mid to high single digits, benefits were lower or better in the high single digits and the combination of other expenses, a variety of them, were better by or lower by 10 basis points year over year. So again, it's kind of the core control of our operating expenses were all in pretty good shape this quarter.

Central expense was higher year over year by minus 8 or minus 6 basis points without gas. As I mentioned earlier in the call, increased IT spending related to modernization showed higher year over year costs of 7 basis points, 6 without gas deflation.

I already mentioned earlier the stock compensation which was 12 basis points or 10 basis points without deflation. I also mentioned that again because of certainly the stock price increase, but also importantly the fact that there is more employees hitting 25 and in some cases 30, in a few cases 35 [indiscernible] the total impact for the year, more than half of it based on our estimates is the impact in Q1 with about a third or less of that amount in each of the coming three quarters year over year, so still it's going to be higher year over year, but not as high that increase was in Q1.

Finally, quarterly adjustments, again related to the $22 million non-recurring legal and regulatory items that I discussed, so overall good expense control, there's plenty of things and hopefully I've been able to elaborate to shed some light on the components of that.

Moving down the income statement, pre-opening expense was higher by $11 million or 4 basis points higher. We had nine openings last year, including one relocation; 13 this year including two. There's other pre-opening items in terms of countries and some other things, but overall no big surprises there. Our total reported operating income in Q1 was down $3 million from $770 million last year to $767 million this year.

Below operating income, reported interest expense in Q1 came in at $33 million versus $26 million a year ago, so lower by $7 million. Interest income itself was lower year over year by about $4 million and the other component was lower by $3 million year over year, that's primarily related to various FX related transactions. Sometime that's a positive, sometimes that's a negative, never that meaningful for the year in its entirety generally.

Overall, reported pretax income was down 2% versus last year, coming in at $762 million, down from $779 million pre-tax a year ago. Again, several items impact the year over year earnings comparison which I discussed earlier in the call.

In terms of tax rate, our corporate tax rate this quarter was up about a percentage point, coming in at 36.1% compared to last year's first quarter rate of 35.2%. The higher tax rate year over year resulted from a few discrete items going to the increasing tax rate not reducing it and to a little extent lower earnings penetration from our foreign country operations where tax rates are generally lower than our income tax rates for the United States.

Now, for a quick rundown of other topics, the balance sheet as in the recent past is included in today's press. I'll point out a couple of items. Depreciation and amortization for Q1 came in at $271 million. Accounts payable as a percent of inventory on a reported basis was pretty much the same year over year, last year it was 101%, this year 100%. Taking out non-merchandise payables, last year in non-merchandise payables as a percent of inventories was 92%, this year at quarter end it was 90%.

Average inventory per warehouse on a reported basis was up a little over 3% or $524,000 to $14.9 million. Again, ex FX, it would have been up about 6.5% or $960,000, assuming flat FX. About $250,000 million is electronics and what we call majors and about $160,000 is apparel, both built up inventory heading into the Thanksgiving week, Black Friday and Cyber Monday.

As you could have extrapolated from our number, our November reporting, where we reported the four weeks of November, the 12-week first quarter and the 13-week retail reporting calendar [454] the implication there of course was that the last week which is really the first week of Q2, which is Thanksgiving week, was pretty strong.

The balance of the departments have been selling well, like hardware, housewares and toys, so really no issues in inventory levels going into the last few weeks before calendar year end. We’re in pretty good shape.

In terms of CapEx, in Q1, we spent a little over $700 million and our estimate for the year is to be – most likely CapEx would be high $2 billions, say $2.8 billion and $3 billion. This compares to CapEx last fiscal year of $2.4 billion.

In terms of dividends, our quarterly dividend continues at $0.40 a share, or $1.60 annualized. This represents a total annual cost to the company of around $700 million. In terms of stock buybacks, in Q1, we bought back a total of 898,000 shares for $130 million at an average price of $144.88.

Next topic, Costco online, we’re now in five countries, having launched Korea November 10. We’re in the US, Canada, UK, Mexico and Korea. For the first quarter, sales and profits were up over last year. Q1 e-commerce total sales were up 15% on a comp basis, a total and comp basis, up 19% on a comp basis excluding FX. And again, it represents a little over 3% of our sales.

We've been asked a lot of how, again, the week of Thanksgiving, Black Friday and Cyber Monday, you name it, e-commerce sales were quite strong, up 28% and up over 30% in local currencies.

New initiatives, again, it was few years ago that we re-platformed the site. We've continued to improve our mobile apps and there's room to [indiscernible] efforts with our inline efforts. We've added a few categories like apparel, hard line, KS items. We've greatly improved timing of shipments by shipping out more than just one depot across the country. And again, we'll expect to see e-commerce and other international markets in the future.

In terms of some of the others out there that are buying from us, we continue to provide merchandise for sale on the Google Shopping Express. This is now being offered in six markets, Bay Area has recently been expanded, LA, Manhattan, and more recently Chicago, DC and Boston. We've increased our offerings in categories and currently testing fresh foods available in a limited group in each of the San Francisco and LA markets.

We're also providing merchandise to Instacart now in 16 markets throughout the United States, Boxt in three markets and we're also doing some business with Jet.com in the three cities where they have their distribution centers. Outside of here, Alibaba Tmall, we currently offer just over 200 SKUs on the Tmall site, with a heavy emphasis on Kirkland Signature items. It's going well and we're certainly building some recognition for the cost going to Kirkland Signature names. We had a very successful Singles' Day on Alibaba Tmall receiving over 300,000 orders.

Next on discussion, expansion, again, last year opened net new units of 23, so about 3.5% square footage growth. This year, again, plans for up to 32 units. If we achieve that, it'd be about 5% square footage growth and I already mentioned where those would be. Also as of Q1 end, some of you want to know what our square footage is, at Q1 end, it stood at 1,547,000 square feet.

Lastly, our second quarter fiscal 2016 scheduled earnings release, that will be for the 12-weeks ending February 14, will be after the market closes on Wednesday, March 2, with earnings the following morning on Thursday, March 3.

With that, I'll turn it back to Brandy and be happy to open it up for questions. Thank you.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question is from Charles Grom with Sterne, Agee.

Charles Grom

First question, a lot of moving parts with some of the one-time items, I know you guys don't give guidance anymore, but I'd be curious how the quarter overall performed relative to the expectations that you would have budgeted back in August?

Richard Galanti

We beat them.

Charles Grom

You beat them? Okay. Second question, when you look at new member sign-ups, how has the trend been by age group? I'm curious your ability to attract younger customers given the success of Prime and other programs out there. Have you guys started to look at the signups by age group, et cetera?

Richard Galanti

We have and I don't have the most current month's detail, but from a month ago budget meeting, we're getting – first of all, the average age of a Costco member has come down. I think a few years ago, we were about four years older than the average in the US, now we're a little under two years older. About a third of our new signups in recent months have been millennials and albeit I'll make it a point and provide a little more color on that each quarterly earnings release.

Charles Grom

The last question for me just on the gross margin, it's the first time in a long time that all four categories have been positive. Just curious if you could provide a little color maybe by category what's driving that?

Richard Galanti

I think the one that's historically in the last many quarters, that's always the one that's a little volatile and volatile is mostly defined as down year over year is fresh foods. And that has to do with the fact that commodity prices have increased, we maintained prices. No doubt, things like rotisserie chickens and the like. And I think there's been a little bit of deflation in some of those categories and some meat, but also our volumes are particularly strong.

When you got a low double digit comp in produce as an example, that's going to help you, because its sales are strong, availability of products is good and spoilage is less. So those are the types of things that help you in fresh foods. I think the strength in electronics has probably helped us. Those are the things that come to mind. I don't have – organics is helping.

Organics, as I mentioned before, it's kind of a win-win for us. We get for us a fuller margin, a more fair margin within the confines of what we limit ourselves to and it in our view creates even a greater competitive mode given that's where sometimes retailers will try to make [war] [ph].

Charles Grom

And your organic penetration stands at what at the current time?

Richard Galanti

Organic, $4 billion plus, it's still growing very strongly, but I don't have the detail in front of me. Sorry.

Charles Grom

Okay, great. Thank you.

Richard Galanti

One other point on the soft lines, our apparel has been pretty strong too in terms of apparel basics. And so that's generally a full margin business.

Operator

And your next question is from John Heinbockel with Guggenheim Securities.

John Heinbockel

Richard, a question on the fresh food deflation and I guess maybe it behaves a little bit differently by category. But if you think about meat and dairy in particular, is that less of a benefit to you margin-wise and more of a volume benefit just because you pass the declining prices through more quickly than most of your competitors by design and so it's probably more of a help to volume than margin or no?

Richard Galanti

Yes, it's more of a help to volume. If anything, we'll bring price down and we'll always err to the low side. So if we have a calculated margin that's making the numbers up, but $8.15 a pound is going to be $7.99, so you have all those things working towards that.

John Heinbockel

The price elasticity on that is pretty high?

Richard Galanti

Price on strip steaks or items like that, yes. When you could hit another dollar a pound, if you will, lower or a few dollars a pound on some items that drive business. And needless to say you've been in Costco and talk about massing out big good-looking stuff, that's fresh foods is where we shine.

John Heinbockel

You said e-commerce growth was down a little bit. Is that purely mix?

Richard Galanti

There's been no comment, nothing that was called out specifically why that is and that's so I'd assume it's mix.

John Heinbockel

And lastly, the leverage that you've gotten in core operations was better than we've seen in a couple of quarters. It's pretty broad-based. Is there anything you're doing differently whether it's managing labor, benefit design that would have – because comp wasn't that different versus prior quarters. So is it something you're doing internally to manage those items?

Richard Galanti

I wish we knew more here, but I mean, everything we do every day and I'm not trying to be cute here, but certainly we continue to focus on things like basics like overtime hours, every four weeks when we have an all-hands budget meeting here, each of the 16 or so senior VPs or country managers of operations get up and talk about things that they've done in their region to be more efficient.

And I think that pays off. We have focus items that they talk about each month; they talk about other things, working with buyers to create more seamless movement. All those things we really spend a lot of time on. One of the things that I think benefited us are assumptions for healthcare cost, notably US where it’s most expensive and it’s most inflationary, we’ve done a little better job of that.

It was little over a year ago that we made a few changes in the plan in terms of primary caregivers primarily within the plan, and that changed a little behavior, not that big of an impact to the employee, but a better management of that. So I think we’re still getting a little benefit of that there. But it’s in the core payroll as well and I think that’s a combination of lots of little things like I mentioned.

Operator

Your next question is from Simeon Gutman with Morgan Stanley.

Simeon Gutman

Curious if you can help diagnose the consumer, I know we saw some volatility in your monthly comps and there’s been some unevenness in other parts of retail. You gave us some good color in November, but what do you think is going on? Does spending appear back to normal? I don’t know if it was just a temporary hiccup?

Richard Galanti

I remember, it’s October when we said one month does not make a trend. And then the first couple of weeks of November weren’t terribly exciting and then it got more exciting. And middle of November and late November, it was quite a bit stronger than the first part of November.

So again, I think we weren’t really concerned when it was – when frequency was a three instead of a four, but overall comps continue to be well, our markdowns are in good shape, even though inventories a little higher, and so I think we still feel cautiously optimistic and certainly confident about what we’re doing right now.

I think if you’d ask me what surprised me in the last month versus the last couple of months, electronic has finally turned and that’s I think a function of people coming in, pricing keeps coming down. I think our fresh foods has been great. The fact that many times I'm explaining the fresh foods year over year margins are down a little, they were up a little. That's all good. So I think that reflects well on us. I can't speak to the consumer outside of that though.

Simeon Gutman

So other than electronics, the complexion of what consumers are spending on looks back to normal, back to the old cadence?

Richard Galanti

Yes, but that doesn't mean anything for tomorrow. But what's nice when I look at the November results which I have in front of me, underlying in the US which is the big piece here, so it does take – relates the FX issue. Soft lines was low double digits, fresh notwithstanding some deflation and the average sale in meat was good. Yes, and so I hope it will continue, stay tuned.

Simeon Gutman

And just a follow-up gross margin because I guess the printed number is the highest number since our model goes back to 2003. And you mentioned the four core categories were good and I think you attributed somewhat to mix. But big picture, the mix of product, that will probably keep benefiting you. Can you give us a sense on the leverage with suppliers? How much of that side of the coin is helping you as well?

Richard Galanti

I haven't heard anybody talking about major changes in leverage. We are – I think if you ask our suppliers generally, we are typically front and center with them. When freight rates have come down as you might expect some suppliers are reluctant to – they are waiting for us to call them back to offer that. Global sourcing I think is helping us competitively a little bit. So overall I think we’re still tough.

I mean, there have been some suggestions out there that some retailers going back to manufacturers to insist on extra moneys. When we read that and hear that, we hear it from as you might expect and we have to understand that there’s some people out there that sell all of this and we share things each way. You’re going to find – we’re going to go back and make sure we get our share of that. So I think we continue to be tough; I don’t think there’s been any change in that.

Operator

Your next question is from Michael Lasser with UBS.

Michael Lasser

Can you describe what you’re doing to prepare for the transition to VISA? And as you make that transition, how are you going to inform your existing members and new potential members of the switch?

Richard Galanti

I’m glad a lot of that’s in the operations and membership marketing areas. There’s a lot going on, needless to say, between our company and the new issuer Citi that’s going to be coming out. Citi and American Express are currently discussing what they need to be doing in terms of that transition.

And again, contractually there’s not a lot we can say at this point, but rest assured it’s going to take several weeks to transition, but the assumption is that the existing members with the existing cobranded card will be getting new cards in the mail on or about the time of the actual transition. And it will be hopefully as seamless as possible to them. Once we’re allowed to communicate to our members about the new program, which again contractually we can’t do that until that time, as you would expect like anything we do, we’re going to let everybody know and put it in big letters.

Michael Lasser

Should we factor into our models a potential disruption from the transition? Will there be a period of when you take both VISA and American Express for a period of time?

Richard Galanti

There may be, again that's still influx. There are some possibilities of that. But whether there's an exact transition, a binary transition or an overlap period of time, I don't really see a lot of disruption on that side. As you might expect, it's a royal pain to do this, but it's what we do. You've got teams of people in operations that are working with our people in membership marketing and they are working with the new outside provider to make it as seamless as possible to have the communication out there both in store, via email, via letter. And so I think it's going to go a lot better than one might think. It's just a lot of work to be done.

Michael Lasser

Coming back to the topic of traffic, three out of the last four months traffic has been a little slower than the 4% you had been seeing consistently before that period. Are you just running into a point where there's now either limitations on how frequently some of your members, some of your most loyal members can shop or limitations on the throughput that some of the stores are having based on the level of traffic that you're already seeing in those locations?

Richard Galanti

I think in terms of the level of throughout, we keep doing a better job of that. We keep – in my view, in my own calculations, we keep raising the number of amount of annual volume a warehouse can do. Certainly, there will be somebody in line saying God, why did I come on Saturday afternoon, but at the end of the day that's not an issue.

Look, I remember in calendar 2009, for calendar 2009, the first year after the bad economy hit, we had a frequency number of around 4. And I was reminding people that if calendar 2010 was zero, that compounded number of plus 2 for those two years would have been better than our average over the prior 20 years.

And now we've enjoyed seven years, calendar 2009 through calendar 2015 that have been slightly above 4 on average on a compounded basis. So at some point, it has to come down a little bit. We feel very good about where it is. We can't look at any specific factor to say this is why it used to be a 4, in the last couple of months it's been a 3.5. We feel very good about where it is.

Operator

Your next question is from Robbie Holmes with Bank of America Merrill Lynch.

Robert Holmes

Richard, I was wondering if you could talk a little bit more about partnering with Instacart and Google and maybe how that's going versus your expectations. And also, can you remind us how the membership is impacted by that if it were to roll out nationally? How does membership fee get accounted for in that? And then I have a follow-up question.

Richard Galanti

Sure. Well, each one is a little different. I believe with Google, you have to be a Costco member to go through the Google Shopping Express network. So it doesn't impact membership at all, perhaps it gets a few members because there are some people that aren't going to come in, but now they can get some things delivered to them.

With respect to Instacart, I believe it's the Instacart memberships and of course they buy multiple memberships. Net-net, it might be a slight decline

[Technical Difficulty] all trying to grow their businesses. So I think starting from the point that many out there were concerned, everything is going to go this way and what's going to happen to all this brick-and-mortar.

In our case, we see some changes. The net increase in some of these is that there is a slight improvement in total comp, recognizing you've got a few more visits that are delivered. But it's still a very small thing. And so there's not a lot of knowledge I can give you beyond that.

Robert Holmes

Just the other question was on with the success in fresh food and organic and everything, are you seeing space allocation grow to that area? And if so, where is it mostly been coming from and is there a maximum [Technical Difficulty].

Richard Galanti

[Technical Difficulty] refrigerator and frozen, putting in more vertical stand-up coolers versus the coffin coolers in the deli and cheese areas. So we're getting more out of our space. We've added space. My guess is that there's less incremental space that we can do, but we're still doing it to some extent.

And the other thing is that's an area where we can benefit by turning it faster as well. So a lot of our expansion was to enable us to turn it fast, not only more square footage or more lineal footage outdoors that are more vertical cases, but have more merchandise out there, better presented and easier to grab. And I think we've done a great job in that area.

Robert Holmes

Lastly, the CapEx I think you're saying is going to be up like $0.5 billion or so versus last year. Can you remind us what that extra $0.5 billion compared to last year is for?

Richard Galanti

Sure. Roughly eight or 10 more locations, roughly a few more extensive locations internationally. There is all that other stuff I talked about where we're adding – still adding a few gas stations, still adding a few hearing aid centers. Depots, our infrastructure which is we think a big competitive and profitable advantage to us.

84%, 85% of our goods now go through our cross-dock operations where the average life of the majority of that inventory is less than a half a dozen hours. So we've got a lot there. I believe IT is – I don't have it here. I think that will be – year over year it's going to be $60 million to $80 million. I don't have it in front of me. I'm sorry. But that's a piece of it as well.

Operator

Your next question comes from Christopher Horvers with JP Morgan.

Christopher Horvers

So Richard, I understand your comments on the MFI growth and the underlying trend being very strong. But as you look at the MFI ex FX, it seemed to have slowed off a strong four quarter trend that you saw through the third quarter of last year. So how much of this is social media offers? Are we lapping some big international openings as well? Basically trying to understand what the right underlying trend in MFI growth is.

Richard Galanti

I don't see a big concern there. Some of this is social media. And I know anecdotally one thing we did was living social thing a year ago which was very good. We've not done that again at the corresponding time this year. I've not seen any comments from our membership marketing people when we reviewed the quarter with them of any concerns. There maybe a little timing with openings, international openings, but again we don't see any big trend there that concerns us in terms of trend change.

Christopher Horvers

No trend change? Okay, understood. And then can you help us think about the gas? I know you get this question a lot, but you had some nice gas benefits last year. In the next quarter, you're going to lap I think what was an even stronger quarter, the second quarter a year ago. So maybe anything on how much gas was a net benefit or a net detriment on a year to year basis, quantitative hopefully, but any qualitative comments just to help as we think about this upcoming quarter?

Richard Galanti

We'll tell each quarter, but in Q1, again, one would have thought, one includes you guys and me, that gas profitability would have fallen down a little bit, still very good, historic relative to our history, but versus very strong numbers of Q1 a year ago. We had pretty good numbers this time.

I think year over year it was within $0.01 of profitability, flat to down less than $0.01 year over year. I think we also had a very strong Q2 profitability that may be tough to match, but we're early in the quarter. And Q1 surprised me, I can only be surprised there, but if it does come in a little bit, we'll certainly share with you if it's more than a penny or two delta.

Christopher Horvers

So a tougher compare but you were surprised to the upside on this case and taking that all into account maybe it's not as bad as people fear out there?

Richard Galanti

Right. Again when I say surprise to the upside, we are still down year over year a shade, but again last year was pretty strong and Q2 was even stronger. We'll see how this quarter goes. In fact, if gas prices and oil prices drip down a little bit, that generally bodes well for us. But again, I'm not suggesting it can be as low as last year, we'll see.

Christopher Horvers

And just one last question on the traffic side, I know you said you don't really see a change in the box in the consumer. Does the fact that November was largely driven in the back half of the month concern you at all or is that just an indication of the consumer continuing to wait for the deals that come around Black Friday?

Richard Galanti

If I knew I'd be doing something else, we actually looked at it as a positive. We were starting to get a little concerned is it's slowing down a little bit. I think the fact that we don't put as much emphasis on Black Friday and Cyber Monday, it still did well. But we've got a lot of people coming in earlier that week for crazy numbers of pumpkin pies and the like, all those things can help us. The fact that electronics was strong was a surprise to us. So I don't think we look at it that way at all.

Operator

Your next question is from Paul Trussell with Deutsche Bank.

Paul Trussell

I apologize for any background noise. I am in the airport. But I wanted to just go back first to your color that you provided on margins just to make sure that I captured some of the details that you listed out. When it comes to gross margins to start, I believe you spoke to the actual core of four categories up once again 13 basis points, similar to what we saw in the fourth quarter. You noted that ex the cycling of the one-time benefit from last year, gross margins would have been up an additional 7 basis points.

And regarding the inventory levels, you stated that you feel pretty comfortable with those levels just given how strong the first week of the second quarter was. Is that a fair representation of your color on gross margins and how should we think about that going forward?

Richard Galanti

Yes, but mind you the 7 basis point is a one-time item. The 13 is the core business, it's not like this 13 becomes 20.

Paul Trussell

Correct, on the core, absolutely.

Richard Galanti

Yes, we feel pretty good about that.

Paul Trussell

And then regarding just SG&A again, just for my clarification, making sure my table is clear. Stock compensation, you mentioned was up meaningfully year-over-year, $36 million I believe you said. So about a $0.05 hit or so on a go-forward basis. That will only be about a third of the hit in the next few quarters?

Richard Galanti

What I'm trying to convey is that because of timing, our annual grant to everybody is in late October, because more and more of the recipients, particularly the recipients like myself who has been here 32 years, almost, so you've got accelerated vesting. So the entire hit is now not spread over 5 years. So really that's a timing issue; that's going to help you a little in the future.

But the fact of the matter is because it's October, we've got a big hit in October or Q1, so just taking in the math of what we – if you think about it, the actual hit to P&L this year is a function of those grants that have been made over the last five years and then [indiscernible] adjusted when it vests faster than that accelerated based on tenure.

So not only do you have more people on the plan today than you had – as a piece from five years ago gets fully extinguished and you're adding a new piece, A, this new piece has many more people from five years ago; it has a stock price per share a lot higher; and you've got the vesting.

The vesting in my view being one of the key ones. And so the way it hits, just simple math is that $36 million year over year change is more than half of our expected year over year increase in that line item. So if it was half, in each of the next three quarters, it'd be about a third of 50% in each of those quarters. It's not quite there, but instead of being $36 million, it's going to be in the $10 million to $13 million range or $8 million to $13 million range each period.

Paul Trussell

And then the legal hit, is that fully contained into this particular quarter? And then also on the IT modernization, how should we think about the cadence of those expenses going forward relative to what we saw in 1Q?

Richard Galanti

In terms of the $22 million, again, it's a couple of items that we're still in the process of. That's our best guess of the impact. We don't think there is going to be any big surprises there. If anything, you try to be reasonable and conservative.

Outside of that, in terms of IT modernization, it's a little bit of a broken record here, but there is light at the end of this tunnel incrementally, and I'm hopeful that sometime next year we will see that flatten out and come down. But we got a lot going on there. And again, it's part of our operations. It will come down as a percent of sales at some point in the future or come down certainly relative to the type of increases we've seen. But it's necessary and we're starting to see some deliverables finally.

Paul Trussell

Last for me is just on the international side. Canada and international segment have been able to have a reasonable spread versus the US in margins. I believe some of that's due to a little bit maybe less competition, maybe a little bit less labor costs. As you continue to grow the business and expand into new markets, how do you think about the margins in those segments going forward? Can it maintain a little bit of a reasonable spread versus the US?

Richard Galanti

I think all things being equal Canada is going to continue to be more profitable than the US and some of these other countries are going to continue to be even more profitable than that, not all, but some of them. We have no illusion that some of the ones that are really outsized profitable come down a little overtime, but Canada is mature, still growing a little in terms of new units, still growing nicely in terms of local currency comps and it's nice that we're the only club in town.

That being said, we're still are own toughest competitor. We have a little extra margin there, not a lot. We have a lot lower healthcare cost as a percent of sales. So there is other things that help us up there, not just little extra gross margin.

Operator

Your next question is from Brian Nagel with Oppenheimer.

Brian Nagel

The question I have, Richard, you called out electronics as a point of strength. Could you comment specifically on the TV category? And to what extent some of the new innovations in TVs are helping drive better electronic sales? And a follow-on to that is as the holiday season has gotten underway, what type of price promotions you've seen throughout the sector on TVs?

Richard Galanti

I don't have the quarter in front of me, but for the four weeks of November reporting which would be through the Sunday after Thanksgiving, those four weeks ended then, within majors which was up again ex FX in the mid teens for the month, I think I said it was in the low double digits for the quarter. TVs for the month were up both in dollars and sales in the mid 20s. So it's quite strong. That maybe because last year was a little weak.

I don't know; I don't have that in front of me. But it certainly was strong. I think there is a little bit more promotions; cell phones are strong; tablets are strong – I'm sorry, tablets have come down a little bit, but phones are strong and those are the big things. Video games are strong, again all those other strongs or little weakers are dwarfed by television sales within electronics.

I think the technology, the 4K is helping, but the prices are coming down as well. I was there across the street yesterday and you've got smaller flat screens with great quality less than $200. You got bigger TVs less than $1,000. You got as well the giant HD 4K whatever under $3,000 and under $2,000, depending on the size and some of the new technology. So I think all those things are helping us a little bit on that category.

I pointed out also because it's one of those we continue to get asked about as .com continues to take market share in electronics and the impacts to other brick and mortars over the last few years. I think Best Buy has been a little better on TVs as well, but certainly this has been a standout for us of late.

Brian Nagel

And one follow-up question. I know you addressed this in your prepared comments too, but the inventory growth in the quarter, so if you look at it on a year-on-year sequential basis, it did tick higher here in fiscal Q1. What explains that?

Richard Galanti

The two biggest components of that $900,000 ex FX number year over year is electronics which is about $25,000 and that's planned [in new and find] as expressed in these sales numbers. And apparel and again we are out there in mass and these are basics, I mean, we're not going to be left over with lot of red and green Christmas dresses, because that's not what we sell. I mean, we're doing fine.

We feel we have no concerns about our inventories, our markdowns, something I know we've learned years ago the cheapest markdown is the first markdown and the quicker you get rid of stuffs that that had problems and our markdowns overall have been nothing to be concerned about.

Operator

And your next question is from Matthew Fassler with Goldman Sachs.

Matthew Fassler

My first question just want to get a little more clarity around this transitional period as you have to cease signups for the card, you talked about it in terms of EPS impact on the quarter that you just reported and some residual impact over the next couple quarters. As we think about where this shows up in the P&L, is there any discernible impact on the top line? And if you could kind of dimensionalize the impact on the member fees as well just to understand where we would model for that to happen?

Richard Galanti

We don't have any new cobrand cards being signed up right now. So that's impactful a little bit to the membership line, not a lot. 99% of – that's going to go to sales. Everybody who has a cobrand card currently is still using it. So there is no impact there. Again, what I tried to do recognizing that $1.09 reported figure was going to raise some questions, we just looked at what are the things that we can really look at. Given that our sales continue to be strong, we're not really looking at that line to see how much sales do we estimate we're losing.

I assume we're losing, in theory, you're losing a sale for somebody that signed up as a member that can't sign up for the cobrand card. They are still buying from us, they don't have the cobrand card, they don't have that reward. They're probably using some other Amex reward card, recognizing at its current strength, Amex is about 40% of our sales.

There are still 60% of people that aren't using Amex, whether they're using debit or a very old house card from – we don't own it, some years ago or another Amex card. So we don't see a big impact there. Is it greater than zero, the negative impact, of course, but again given where our sales numbers have been, this is something that there is specific pieces that moneys earned for new signups in the equation and so we pointed that out.

Matthew Fassler

Second question, you talked about the seasonality of stock comp expense and the bulge you saw this quarter. Just to confirm what you talked about we saw this past Q1 and what you talked about for the rest of the year. It seems to be seasonally a lot like what you had last year even though it's a bit different from what you had over the prior few years. Is that an accurate way to think about it?

Richard Galanti

Yes. By the way, comp is – it is part of our comp and it is part of SG&A. We have always pride ourselves for many years we never changed the number of shares. So as the stock compounded at 19% a year, that piece of 3,000 or 4,000 people's compensation improved dramatically. As you may recall a couple of years ago we reduced the number per recipient at whatever level that was by I think 15% and again we just did it again in the grant that just happened, notwithstanding you're still seeing this big increase because of just how that works.

Matthew Fassler

And just another quick follow-up on the demographic piece. You gave us a couple of interesting numbers. A couple different ways to come at that question I guess, is the average age of a new member changing for you? Has that been moving in one direction? You talked about it relative to the national average and presumably that couldn't happen without the average age coming down. But without knowing what the national average has done at our fingertips, kind of hard to know.

And then also, members in multifamily dwellings versus single family, if you think about millennials staying in that kind of environment and multifamily in general gaining share from single family. I'm not sure if you're able to look at it that way. Any sense of how you're faring with that cohort?

Richard Galanti

I haven't seen anything that's presented to me that way. I've said a couple of times in the last many months when people talk about millennials, I think the good news is we're getting more of them and things like organic certainly help, social media helps a little bit, but millennials is going to be an issue for the total pie in general if people move home after college for a period of time, if they move into a smaller place, if they get married later and if they have fewer kids.

It's going to rain on all of us, so we're certainly having increasing the share we get on those people who will help, but we're going to keep driving value. And given the flexibility of the types of things we can continue to sell, we'll see where it goes. But we have not looked at that. If we start looking at that, I'd be scared.

Operator

Your next question is from Oliver Chen with Cowen and Company.

Steven Zaccone

This is Steven Zaccone on for Oliver Chen. Thanks for taking our questions. Just two quick questions. As you look to the remainder of 2016, are there any areas of the assortment that you have an opportunity for improvement in your view? And then secondly, we just had a quick question regarding the E. coli situation. Have you seen any traffic disruption from the headlines? It does appear that you have the situation contained but just curious have you seen any traffic disruptions?

Richard Galanti

On the latter, no. That was contained pretty quickly and the information was communicated pretty quickly. And I believe that the last possible episode related to Costco of someone being fallen ill was November 1, so we're trying to pass that. Thankfully nobody was extremely hurt. There were a couple, there's a few that did go to hospital and I understand that they're all doing better now. So nothing new as it relates to that.

And in terms of the other question in terms of what's new, again it's more of the same. I can't give you anything specific at the top of mind. Organics continues. At KS, we're doing a few more things, but that's steady as we go.

Operator

Your next question is from Kelly Bania with BMO Capital Markets.

Kelly Bania

Just wanted to ask another question on the transition to Citi. As we get closer to that transition in the spring, just curious how you feel about it? Sounds like there is a lot of preparations involved. And maybe you can just remind us what's different about this in the US versus what you did in Canada a couple years ago? And maybe what you learned in that transition process?

Richard Galanti

Well, it just takes time. I think the big difference is in Canada the new issuer was not able – did not purchase the portfolio from American Express and therefore it’s what referred to as a de novo program where our customers, members have to sign up and reapply for credit. And so that’s a little more disruptive. Now, it’s a MasterCard up there and so there are many people out there that have a MasterCard in his or her wallet already. So it’s not something they use.

And then in terms of auto renewals, part of our renewal rate is the fact that you have some members that do auto renewal, which as you might expect statistically has a slightly higher renewal rate because it’s auto. And the assumption here in the US is that the portfolio will be – the transition will include the purchase of the portfolio and I think the language which we’ve used in the past is that that’s what we anticipate because there is always a chance that something can happen, but we’re working towards that end as you would expect the issuers out there.

So again, recognizing that Canada is 10% of our company and the US is 70%, so these are bigger numbers. I would guess that if you look at the $15 million I pointed out as it related to just revenues we get for signing up new cobrand cards, even if the same percentages occurred up there, it wouldn’t either be worth calling out in terms of the company as a whole. So it’s just going to take some time. I’m just trying to share with you what I can at this point. Nothing big is going to happen, we’ll get through it, and we’re very excited about the next many years under a great program.

Kelly Bania

Any color you can provide on what percent of members do use the auto renewal and anything else we should think about just modeling?

Richard Galanti

I don’t have that at my fingertips, but I probably would – we wouldn’t share that. As many as possible would be the answer. It makes it easier for the customer and certainly it gives them a reason to more likely renew.

Kelly Bania

And then, just another question. You mentioned I think two new business centers planned for this year. I was just curious if you could talk about how those are working? Any relative profitability versus a typical club and just what you think about that format going forward?

Richard Galanti

First and foremost, we’re opening regular warehouse clubs. For a number of years, we had anywhere from I think six to eight business centers that were doing okay, slightly profitable, but not setting the world on fire. There were a lot of changes that was made to it a couple of years ago and they are growing nicely. They are more profitable than they had been.

And it’s another avenue, it’s going to be a lot smaller footprint in terms of how many units we have than a regular warehouse, regular Costco warehouses, but we’re doing this just like we’ve done everything pretty methodically. On a base of 10 or so, we’re going to open a couple. And so it’s not like we’ve discovered something that we’re going to go from 10 to 20 overnight in one year.

So yes, it’s good and it’s a positive business for us and it certainly is a focus on the business member. We also from time to time identify items in the business center that makes sense to sell in all of our locations. So we think it’s a positive. Some of the examples also is where we’ve taken an old Costco which is smaller footprint, perhaps not as well located for our general population member, as we’re relocating an old unit, we will convert that other one in that city into a business center. So that’s been helpful to us as well.

We did that in South Atlanta; we did that in Chicago I think in Bedford Park. I believe the New Jersey location is a relocation where Hackensack went to Teterboro. So I mentioned that we opened a new one in Teterboro that's a re-lo of Hackensack which is now over that several month period is being converted into a business center. So we think it's good. When asked what's driving our earnings growth and what's driving our whatever, I've always said it's a lot of little things and this would be one of them.

Operator

Your next question is from Meredith Adler with Barclays.

Meredith Adler

I have one quick question. Can you just remind me of the timing of the new credit card?

Richard Galanti

Our current relationship expires March 31 and there is a window of few months there post that this could extend. So it will be sometime between April and December is my best guess at this point.

Meredith Adler

And then you guys are still working very hard on your technology modernization. Can you talk about whether you've been pleased with the timing of everything and whether all the new systems have been rolled out smoothly? Technology is notoriously late, but how is it going for you guys?

Richard Galanti

Smoothly would be an overstatement. I mean, I think in the beginning of time when we talked about this starting about three or four years ago, we said this is our best guess and I have jokingly said whatever you think it's going to do it's going to take twice as long and cost twice as much. Anybody that's gone through it, I think generally experiences that. We are experiencing some level of that as well.

That being said, we've got everybody's supportive of it. The deliverables that we have had, sometimes they've taken longer, they've cost more. We've learned from what we didn't know. As we find out, we do a better job on the next thing. And so again overall I think it's costing a little more than we thought, it's taking a little longer, but we're getting some deliverables.

Over the last year, like the new membership system, a new point-of-sale system, a big roll out of really the foundation of our accounting system will be at the beginning of the new fiscal year. So we got a lot going on, but we're getting through it. And I certainly wouldn't quote about it because we know it's tough and it takes long time, but we're getting there.

Operator

Your next question is from Chuck Cerankosky with Northcoast Research.

Chuck Cerankosky

Richard, can you give us a little bit of color or some range on how many stores might be opened this year? You said 32 on the top end. How low could that be and where would you expect some of the shortfalls to be?

Richard Galanti

32 is my best guess. If I had to guess what's the low end, 27 or 28, that just simply means – under 27 example, that means five in the latter half of the year in the original budget that's skewed out a little bit. Right now, I'm looking, we've got seven new units coming in Q3 in this plan and 15 in Q4 with about half of those, probably eight of those in August. So I'm sure a few of those is going to slip.

Okay, some of those have slipped out because this number was 35. So I'm guessing 28 to 32, again it's a fluid number. I don't think we've lost any, but I know a couple of them we've already delayed, might be a year delay for zoning issues. One example there, again we found some things underground that original core testing didn't find. So you're always going to find some things out there like that.

Chuck Cerankosky

Can you talk a little bit about a competitive behavior that you're seeing out there whether it's a reaction of a more conventional stores to what you've been doing? There's not many retailers out their showing the comps that Costco is. Are you seeing any reaction in your channel and outside your channel and especially as you enter some new countries?

Richard Galanti

Overall, no. I mean, we are – and I've said this many times, we are our own toughest competitor and I mean that, in our industry, notably Sams and to little extent BJs, but certainly many locations where we compete head to head. We're in their locations literally every week and I would assume they are in our locations every week. And we feel good about the competitive posture there. I think it helps our average volumes are dramatically higher and that allows you to do a lot of things and I think the nature of our member. So I don't think we see any big changes there other than where we keep doing pretty good.

As it relates to traditional competitors, regionally we look at all kinds of things. In the Northeast, we look at companies like Wegmans, which is a great supermarket retailer that are opening more units. That's in our view our customer, high end customer particularly in the quality of fresh foods, although our fresh foods numbers are pretty good. So I think we're doing a pretty good job.

We're helped by the fact that we can choose to do things like women's athletic wear, active wear where we could literally create $100 million of sales on full margin items that didn't exist a few years ago. And I think our global sourcing initiatives and things that gives us we believe an edge on things like produce, but you can’t do it if you don’t do the kind of volumes we do.

So I think we’ve got some good advantages out there and we are, I think, one of the best and not resting on our laurels. So in terms of .com, again, we’re pretty methodical about it. Some of the things we’re doing are helping, albeit from a [Technical Difficulty] lot of ways and I think we’re getting better at that too.

Operator

Your next question is from Scott Mushkin with Wolfe Research.

Scott Mushkin

I just wanted Richard to get your thoughts here and maybe have the numbers even, what the penetration rate for e-commerce and services like rental cars and travel services and that type, insurance services, what the penetration rate is among your members? And if you have, has it been growing?

Richard Galanti

They’re growing nicely. We do not give out that information. They’re all pretty good businesses. They’ve all grown slowly overtime. Travel is doing very well. Things like car rentals, I can tell you I visited some shareholders recently on some proxy issues and during that I was just giving an example though of our rental car business which has grown dramatically in the last year to well over 2 million rentals a year and a lot of that is online.

And in two different meetings, individuals who prided themselves on knowing how to get the best deal on car rentals went online during the meeting and were able to save of the same car from the same [Technical Difficulty] try it and we got to do a better job of communicating that. So those businesses are growing. They are all generally small percentages of the total, so I think that creates more opportunity for us.

I think I read recently where if we were a car dealer, we'd be the second largest car dealer in the country based on the number of new cars purchased by our members through the Costco auto program. All those are additional reasons to be a member. They're all very profitable and growing. And if they're very profitable, it means we're going to keep getting even better values. So it's all good.

Scott Mushkin

And your e-commerce penetration rate, do you have that or is that something you don't want to talk about either?

Richard Galanti

E-commerce, in terms of – what do you mean by penetration?

Scott Mushkin

What percentage of the members are using your e-commerce offer?

Richard Galanti

I don't have that in front of me. It's probably not as much as it should be and it'll keep growing. And I'm not trying to be cute, I just don't have that number in front of me.

Scott Mushkin

And when we're looking at these things and we're looking at frequency, I would guess that these are outside your frequency, they don't get counted, is that true?

Richard Galanti

Correct. Our frequency is front end transactions at the warehouse. So it doesn't include gas, pharmacy, optical. If you shopped at front end, no matter where else you shop, it's just one transaction. So if you shop just at the gas station, it's not a transaction in terms of our shopping frequency.

Scott Mushkin

And the e-commerce is not ringing up as transactions either? Frequency? It's transactions but not frequency.

Richard Galanti

E-commerce is like a warehouse, so that is adding up. That is 3% of our business. So even if it's growing at 3 times at 20-plus percent versus 7%, it's de minimis to that number. Why don't we take two more questions?

Operator

Your next question comes from Robert Drbul.

Robert Drbul

I just had two quick questions. On the credit card, the $0.02 hit this quarter, is that expected to be something similar over the next few quarters in terms of the impact? I guess the question is when you start to get to the new relationship, will there be additional marketing expense that you would also incur in addition to what is impacting the business today?

Richard Galanti

In terms of the first piece of that question, yes, I don't know if it round to $0.01 or $0.03, but call it $0.02 is the guess. And it's a guess. At the time of transition, their money is baked into the deal, so I don't see any big impact to that hitting our numbers.

Robert Drbul

And you mentioned the Alibaba Singles Day. Can you just give us any insight in how you're looking at China and essentially what you're learning so far from that relationship?

Richard Galanti

We’ve been asked about China for 20 years in about every two or three years, it used to Jeff and Jim and our head of international, Jim Murphy, and now of course it’s Craig and Jeff and our international Jim Murphy and a few others in real estate. And we keep looking. At some point, we’ll probably open a couple of units. But we haven’t pulled that trigger yet to actually go forth.

I would say it’s probable in the next five years, but we got a lot going on. And for 20 years, we’ve never been terribly concerned about we got to get there now. So this gets our name down a little bit, but it’s not like we’ve strategically sat down and said, hey, let’s get our name down for a few years and then go. The Alibaba team all thing happened because they came to us and we did depreciate how many Kirkland Signature items were selling on their site before we sold them directly and at a better value.

Operator

Your next question comes from Dan Binder with Jefferies.

Daniel Binder

You mentioned earlier in the call there was some of these one-time items that we were aware of, some that we were not. Just in terms of things like legal and regulatory, is there anything that we should anticipate in Q2 based on what you know today that we should be factoring in?

Richard Galanti

No.

Daniel Binder

You mentioned a little contribution from international which contributed to the tax rate difference. I was just curious, is that related to start up costs in areas like Spain, just higher losses associated with that or is it something...

Richard Galanti

Not at all. What I was talking about is if you have $100 in Canada earned and year over year in the quarter the Canadian dollar relative to US dollar is down 15%, we bring it down at $85 of income, not $100 of income. And Canada being marginal tax rate, federal tax rate I believe is 26% currently versus actually off a little bit versus 39% in the US.

In some other countries, it's actually a little lower or higher, but generally speaking, I believe the US versus in the nine countries you are, our affected US tax rate – our earnings in the US is quite a bit higher than anywhere else. So it's the penetration of foreign earnings to total earnings, it's that simple.

Daniel Binder

So we had an opportunity to visit your Getafe club in Spain. It was pretty impressive. I think one of the areas that was surprising was the amount of local sourcing you're doing especially in areas like fresh and we heard about some of the export activities with local vendors. I was just curious if you could expand a little bit on what that opportunity looks like when you – not just for Spain, but other countries you're operating in. How much you're doing in terms of cross-border type sourcing for other clubs and whether it's the US or Japan, et cetera, it seemed like it was growing.

Richard Galanti

First and foremost, the big thing is multinational vendors getting the – a lot of times, even with multinational vendors you've got two or three or four geographic world regions. And I remember when we went into Australia and now we have eight units instead of one or two or three a few years ago, still with only eight, there is divisions of multinationals that aren't prepared quite to sell us, make available certain things and certainly sell us at global pricing. That can only change when they get us involved and again since we have that meeting here every four weeks, the budget meeting, that's when that happens. So I think a focus on that has helped us.

As it relates to going into these markets, to the extent there are items in those countries that helps us both ways and I think that's, if you will, I think we do a good job of that. Those are all small little things that help long term. I'll give you an example back in Japan a few years ago, I forget the name of the – there's a very well known what's considered a very premium tea that's a Japanese branded product, that they initially were reluctant to sell us when we entered Japan, even as we had ten or so units.

Once we worked with them to provide a cobranded Kirkland Signature by that brand name, not only in Japan but it sells very well in Eastern Canada and long the West Coast and California, all those things are net positives and not only afforded us an ability to have a premium item with a decent margin and a new item in these other markets where we're strong, that market potential allowed us I think to procure items faster in some of those countries. So it's a win-win. But these are small, again that is a small example.

Richard Galanti

Thank you very much. We're around today if you have any further questions. Have a good day.