Costco Wholesale Corporation (NASDAQ:COST) F2Q10 Earnings Call March 3, 2010 10:00 AM ET

Executives

Richard A. Galanti - Chief Financial Officer

Analysts

Deborah Weinswig - Citigroup

Charles Grom - J.P. Morgan

Mark Miller - William Blair & Company

Adrianne Shapira - Goldman Sachs

Dan Binder – Jefferies & Co.

Robert Drbul - Barclays Capital

Analyst for Mark Wiltamuth - Morgan Stanley

Colin McGranahan – Sanford C. Bernstein & Co.

Peter Benedict – Robert W. Baird

Laura Champine – Cowen & Company

Sandra [Barker] – Montage & Caldwell

Operator

Welcome everyone to the second quarter and year-to-date results and February sales release conference call. (Operator Instructions) I would now like to turn the conference over to Mr. Richard Galanti, CFO. Mr. Galanti, you may begin.

Richard Galanti

Thank you and good morning to everyone. This morning's press release reviews both our second quarter fiscal year 2010 operating results for the 12 weeks ended February 14th and our four-week sales results for the month of February which ended this past Sunday, February 28th.

As with every conference call, let me 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 our 12 week, second quarter operating results. For the quarter reported EPS came in at $0.67, up 22% from last year's second quarter at $0.55. As noted in this morning's release a $22 million pre-tax charge or $0.03 per share was recorded in the quarter related to a change in the company's employee benefits whereby certain unused time off will now be paid annually to the employee. Excluding this nonrecurring charge second quarter EPS would have been $0.70 or a 27% increase over last year's results.

As will be discussed in more detail in a moment, our second quarter results and a comparison of these results with last year's second quarter include several other items of note. They include the following: First, if you recall last year in Q2 we took some very aggressive pricing mark downs on a variety of commodity items estimated at around $0.04 per share. Items like milk, cheese, butter and rotisserie chickens in order to drive sales. No similar events occurred this year in Q2. So that helped the comparison year-over-year.

Second, we had a positive year-over-year swing on gasoline profits. Last year in the second quarter we lost a little money. This year we made some money. Third, LIFO. LIFO was one that actually went the other way. Last year in Q2 we had a $7 million LIFO credit or about a $0.01 per share pick up and despite recent levels of deflation there is no corresponding pick up this year in the second quarter as our cumulative LIFO balance is in a net credit position and you can't go below zero.

Fourth, in the last couple of years we have talked about FX headwinds. We are now talking about FX tailwinds. Our foreign earnings results when converted and reported in U.S. dollars helped us this year in the second quarter by a little over $20 million pre-tax or $0.03 per share. That is assuming FX exchange rates were flat year-over-year, this year's foreign operating results in Q2 would have been lower by that amount.

Lastly, on the expense side while we have made improvement from Q1 a variety of our employee related benefits costs, notably healthcare costs and accruals for both Worker's Compensation expense and bonuses were higher year-over-year in Q2. Healthcare costs continue to be a challenge but we are currently anniversarying when they began increasing in a big way last year in Q3. If you recall last year there were two issues. One is that there is the ongoing healthcare cost inflation. Kind of a double whammy for us over the last 12-15 months has been that as we lowered the number of openings and existing employees turnover has always been low it got even lower over the past year with the economy as it is and we saw the number of covered employees jump from the low 80's as a percent of our total workforce in America to the low 90's. That certainly is anniversarying now as well.

In terms of sales for the 12-week quarter, reported total sales were up 11.3% and as well recently reported comp sales number was up 9%. For the quarter both total sales and comp sales were impacted by both gasoline price inflation and by the strengthening foreign currencies relative to the U.S. dollar year-over-year. On a comp basis in the quarter the 5% U.S. sales increase in Q2 excluding gas inflation would have been plus 2% and the reported 26% international comp sales increase figure assuming flat year-over-year FX rates would have been plus 10%. Still a very good number but not the 26.

Total company comps as you saw for the quarter we reported a plus 9% comp. Excluding both gas inflation and FX changes that would have been plus 3% for the company. In terms of sales for the four-week month just ended it is similar to the quarter. Excluding gas inflation, the 5% reported U.S. comp would be plus 2%. Excluding FX the 26% international figure would have been 10% and excluding both gas and FX February's total company reported comp of plus 9% would have been a plus 4%.

Other topics of interest I will review this morning are opening activities. After opening six new locations in Q1 we opened two new locations in Q2, one in California and the relocation of our Warrenton, Oregon facility. Since the second quarter ended two weeks ago we have not opened any new locations but tomorrow morning we will open a new Costco in Los Angeles and Pacoima. It will be our 117th California location and our plans for the remainder of this fiscal year are to open up to eight more locations, probably seven or eight.

Also this morning I will review with you our online results, our membership trends, a little bit more discussion about margins and SG&A in the quarter. I won't go over the balance sheet as you will notice that was attached to the press release I am happy to report. I will give you a couple of other quick comments including the recent appointment of Craig Jelinek to the title of President.

So let's start with the income statement. Again, on the quarterly results sales for this year's second quarter were up 11% from $16.5 billion last year up to $18.4 billion this fiscal quarter. On a reported comp basis the second quarter comps were up 9%. Now the 9% second-quarter comp figure was essentially comprised of a nine in December, and eight in January, and an eight in February, recognizing our quarter started the last week of November and ended in late February. This 9, 8, 9 if you will for December, January, and February excluding the gas and FX would have been a 4, 2 and 4. So pretty good showing particularly in those recent months of February.

The 9% reported comp for the year was positively impacted by a little more than 3% due to the strengthening of foreign currencies. As I mentioned earlier our international comp which reported at 26% was actually plus 10%. The same thing with gas. The 5% reported in the U.S. would have been a plus 2% without gas inflation. For the quarter, our 9% reported comp figure is comprised of an average transaction increase of a little over 4% and an average frequency increase of around 4%.

I might add the frequency trends during the past three months of December, January and February were a plus 5, plus 3.5 and about 4. This now going over a year of seeing pretty good frequency numbers on top of pretty good frequency numbers a year ago. January/February of course was a little negatively impacted as a result of both the heavy rains in California and the unusual amounts of snow in the Northeast, Midwest and Southeast. For February of course it was also impacted by the snows in the Northeast.

For the February reporting month much like the quarterly comps again our 9% reported number, taking the gas and FX out was a plus 4. Within the 9% for the month of February that is comprised of an average transaction increase of about 5% and again an average frequency increase of about 4. Again, that transaction increase of 5 is pretty much FX of 3 and gas benefit of a little over 2. So net of those two average transaction increase was about flat. Cannibalization pretty much was consistent with what it has been of late. A little over 0.5%.

IN terms of sales comparisons by geographic region, for the quarter the Midwest and the Southeast were the strongest followed by a pretty good showing in the Northwest. California was actually a bit improved also and the weakest U.S. region was the Northeast, of course impacted by record setting snow season. Internationally in local currency we are doing quite well as you saw from that plus 10%. Despite economic turmoil everywhere

Canada is up in the mid teens in local currency in the quarter. The rest of the countries are averaging up in the high single digit comps.

A little more color on February sales as we are reporting these figures today as well instead of tomorrow, in addition to the benefit from gas inflation and FX, we also benefited a little bit from a calendar shift for the Super Bowl. As you recall from Bob Nelson's call in January we estimated that the way the Super Bowl hit the calendar this year we estimated that January had been negatively impacted by 50-100 basis points. Correspondingly February would have benefited from that. We also went through and talked to our operators and looked at how the weather both in California as well as the significant snows throughout parts of the country particularly in the Northeast and the estimate there was that was about 1-1.5%. So probably the net of those two is a slight detriment to February but it is a guess at that.

On a regional and country basis, the U.S. regions with the strongest February results were the Midwest and southeast, again followed by a good showing in the Northwest. Again, California continued to improve a little bit relatively speaking. The weakest U.S. region was Northeast. Again greatly impacted by a record setting snow season. Internationally Canada for the month was up in the high single digits in local currency and the rest of the countries are averaging in the mid teens comp figures for February.

As reported in January overall deflation in the food and sundries category appears to have finally be abating such that year-over-year unit pricing decreases that had been running down minus 1% to minus 3% during recent months were essentially flat year-over-year in February. Looking ahead, March sales which is a five-week reporting month will have 34 selling days this year compared to 35 last year. This has to do with the timing of the Easter holiday which is one week earlier on the calendar relative to last year. The March reporting period will end Sunday, April 4th which is Easter and will be reported on that Thursday, April 8th.

In terms of merchandise categories for the quarter within food sundries the average sub-category was positive in Q2 ranging from a plus 3 to a plus 10. Within the hard lines comp the strongest sub-categories were sporting goods, hardware, health and beauty aids and lawn and garden with both office and majors being small positives. Within the mid teen soft lines comp most every category was strong ranging from a 5 to a 25. Some of the house related, smaller ticket items like house wares, domestics and things like that and small electrics, domestics, home furnishings were stand outs within the soft lines category. In fresh foods much like food and sundries was positive with all sub fresh food categories positive as well. In the mid low single to mid high single digit range.

Moving onto the line items on the income statement, I will start with membership fees. Reported membership fees were up 8.5% or $30 million to $385.8 million which was 2.10%. That is down six basis points. Excluding FX, this includes the benefit of the strengthening foreign currency when we convert it into U.S. dollars that 8.5% dollar increase would have been 5% or a $19 million increase on a flat FX. Now I will also mention that when we talked about both membership, margin and SG&A the gasoline inflation if you assume again flat gas prices that minus 6 basis point number with the higher gas inflation number makes the sales denominator in all of these calculations higher, making the actual numbers lower. That six basis point negative would have been flat year-over-year excluding gas inflation. So we think a pretty good showing overall.

In terms of membership, continued strong renewal rates. Continued good penetration of the executive membership. Despite only one net new opening this year in the quarter our new membership signups in Q2 were actually the best they have been in awhile, up 5% year-over-year in the fiscal quarter. In terms of number of members at Q2 end, we had a little over 22 million Gold Start, about 5.7 to 5.8 million primary business, a little over 3.4 million add on, a little over 31.1 million total primary and just under 57 million including spouse cards. That number, by the way, is just under 60 million if you include Mexico which we realize those numbers aren't on our income statement.

At quarter end, February 14th, paid executive member base was 9.6 million, an increase of 340,000 or 4% in just the 12 weeks since Q1 end. So between new sign ups signing up as an executive member as well as some pretty successful conversion programs out there, averaging 28,000 a week increase in the quarter, one of our higher results in the last few quarters.

In terms of membership renewal rates, again continuing strong at Q1 end and at Q2 end. Business renewals were at 92%. Gold Star in Q1 was 86.0%. it was actually 86.1% at Q2 end and all told 87.3% for the company in Q1 end and that tweaked up to 87.4%. This generally has been running in the 87.2-87.5 range quarter in and quarter out for the last couple of years on a quarterly basis.

Going down to gross margin, gross margin the second quarter was higher year-over-year by 26 basis points from a 10.42 last year to a 10.68. Jot down the following numbers and we can go through it. We will have three columns, Q4 2009, Q1 2010 and Q2 2010. The line items would be core merchandising. The second line would be ancillary businesses. The third line item would be 2% rewards. The fourth line item would be LIFO. The last item would be total.

Going across, core merchandising, up 48 basis points in Q4 2009 on a year-over-year basis. Up 15 in Q1 2010 and up 15 in Q2 2010. Ancillary, minus 3 in Q4 2009. Minus 20 in Q1 2010. If you recall the minus 20 it was a year ago in Q1 2009 we had outsized gasoline profits. Then in Q2 2010 a plus 60. 2% reward minus 9, minus 3 and minus 1. Again, a minus here indicating increased sales penetration to those executive members. LIFO plus 22 in Q4, minus 1 in Q1 and minus 4 in Q2. Total was a plus 56 in Q4 2009, minus 9 in Q1 2010 and a plus 26 in Q2 2010.

Now with these numbers in front of us as you can see our overall reported gross margin was higher year-over-year by the 26. Within this 26 basis point figure our core merchandising gross margin contributed 15 basis points to that total and ancillary business gross margin which is principally gas contributed 16 basis points. These plus 15 and plus 16 basis point figures are actually a little more impressive when you consider the sales penetration of our higher margin core business was down 2% in Q2 year-over-year again related to the fact that gasoline inflation caused gas sales to be a lot higher.

Whereas the sales penetration of our ancillary businesses again [opposed] to gas sales which is a lower margin business was up 2%. The sales penetration of our core merchandising business being down, so while gross margin are up in core merchandising business recall core merchandising business is in the high 80’s as a percent of total sales is comprised of food and sundries, hard line, soft lines and fresh foods. They were higher year-over-year in the quarter. Margins on those departmental sales year-over-year Q2 the margins were higher by 54 basis points. That translates into the plus 15 when you account potentially for the gasoline inflation.

The respective merchandise category gross margins again that 54 represents a range from 26 to 75 basis points with the high end being I believe food and sundries but you will recall that is because we had those aggressive pricing last year on a lot of commodity items. Lastly, keep in mind as we discussed in terms of aggressive pricing on commodity items if you exclude the aggressive pricing mark downs food and sundries gross margins were still up 13 basis points year-over-year on food and sundry margins based on divided by food and sundry sales.

The impact from increasing penetration of the executive membership was one basis point. LIFO as I mentioned we had a $7 million LIFO credit last year versus zero this year. That would be a detriment to this year’s margin on a year-over-year comparison of four basis points.

Before I go on to SG&A again looking at these numbers the way I looked at it was we start with that core of 15. The sales mix gas was 24. That would bring the 15 up to 39. Then taking out the aggressive pricing was 17 because that is an unfair comparison since we did that last year and not this year. So you get something in the low 20’s. This is not an exact science but I think the merchandising core of plus 15 is representative of what really happened in the quarter.

In terms of moving onto SG&A. SG&A percentage in Q2 over Q2 was higher or worse by 9 basis points coming in at a 10.20 compared to a 10.11 last year. The $22.5 million non-recurring charge related to the change in employee benefits represented a detriment of 12 basis points so really that minus 9 you might look at as a plus 3 excluding that charge. As a result, an improved result from q1 nonetheless. Again, there is a little bit of prudent elaboration in SG&A given the fact that SG&A benefited by 24 basis points because of the gas sales inflation. So again we will write down some numbers and I will try to give you an explanation here.

Again, three columns. Q4 2009, Q1 2010 and Q2 2010. The line items are operations, central, stock compensation, quarterly adjustments, total and going across operations minus 61 in Q4 2009, minus being higher or worse. Q1 2010 minus 16 and Q2 2010 zero. Central, minus 8, minus 3 and plus 2. So again as a percent of sales central was better year-over-year. Stock compensation minus 1, minus 3 and plus 1. Quarterly adjustments plus 7, plus 18 and minus 12. Again the minus 12 is I mentioned in the quarterly earnings release. For a total of minus 63, minus 4 and minus 9. Again, a little editorial here. Operations in the core operations was flat year-over-year in Q2. Again it is mostly about sales mix change just like with gross margin percentages where increased gasoline sales penetration hurt us and correspondingly helped us in SG&A by a little more than 20 basis points.

However, the combined negative impact of benefits costs including healthcare, workers comp and bonuses was a negative 24. I will go through that in a second. So excluding those higher costs those are real costs but excluding those the rest of operations actually improved a little bit. Payroll and various other direct controllable expenses. Our central expense again was lower or better year-over-year by two basis points and I mentioned specifically stock compensation better by one basis point.

Overall not a bad performance. Again the way I look at it is we start with a minus 9 for SG&A. We add back the 12 for the nonrecurring quarterly charge to get to plus 3. The gas mix helped that by a little over 20, 21 to 24, so you get something about a minus 20 in terms of what it looks like. Now that roughly 20 basis point detriment is more than that in health, worker's comp and bonus. Health we talked about and as I mentioned we are anniversarying some of the big increases from a year ago. We are hopeful that number on its own will come down because we have now transitioned to the higher percentage people under the plan. I don't think that is going to go a lot higher now.

On worker's comp that has as much to do with actuarial adjustments to the number in each quarter. Last year I think it was just a little bit more of how the moons lined up this quarter versus a year ago. The underlying worker's comp expense for the quarter in terms of incidents is not a big change year-over-year, a couple of million dollars difference. The bigger difference is last year in Q2 we had a benefit, a reduction in our accrual and if you recall for worker's comp it is not just your incidents this year it is the balance you have for previously accrued expenses for any expenses that might have a 2-6 year tail on it. Again the actuaries [inaudible] of that.

So we had a pick up last year in that number and a detriment this year or an increase in accruals. My guess, and this is just a guess, is that some of that relates to the fact the same reason that healthcare costs are up over the last year with everything that is going on in the economy and what have you.

The last piece of that, bonus accrual, in the last several years we start with a bonus accrual and by mid-year we set our standards so they are achievable but not easy. In the last couple of years we haven't hit it and have taken back a little in Q2. In this case we are not because we are still hitting the numbers. That is good. But we typically haven't talked about it in a couple of years because we haven't hit it. Again, that is about 6-7 basis points of detriment. All told looking at it all SG&A was higher year-over-year on a real basis given all of these expenses. I think some of them are going to start becoming not being as big of a negative to us. Hopefully we will see some positive sales as well.

Next on the income statement is pre-opening expense. Pre-opening last year in the quarter was a little over $7 million. This year $3.2 million so it picked up $4 million year-over-year. Two basis points better. No real surprises here. Last year's number even though we didn't have any openings in Q2 there was quite a bit of pre-opening related, several post Q2 openings notably as well as some of the ones internationally which are higher numbers and pre-opening structure sooner in life than some of those.

In terms of provision for impaired assets and closing costs, not a big deal either way. Last year we had a charge of $1.2 million in the quarter. This year under $200,000. All told operating income in Q2 was up 18% year-over-year from $399 million to $470 million or an increase of $71 million. Excluding the $22 million charge the $71 million would have been up $93 million.

Below the operating income line reported interest expense was slightly higher year-over-year with Q2 2010 coming in at $26 million up about $800,000 from the $25.2 million in last year's Q2. That small change really relates more to the change in capitalized interest year-over-year which the higher capitalized interest lower the interest expense number. Interest income year-over-year was up by $18 million. It is really the other, as I will explain in a minute. Last year in the quarter interest income and other was up $11.6 million. This year in the quarter it was $29.8 million.

Interest income was actually lower by $3 million, a reflection of lower short-term interest rates while other income which was up dramatically and that is principally a combination of earnings from Mexico, as well as profits from FX contracts used in our business. A portion of that profit from FX historically had been up in operations in the margin and is now down below. So actually we hurt our reported margin this quarter. It is not enough to talk about but that is where it will appear in the future.

Overall pre-tax income was up 23% versus last year's Q2 and up 29% excluding the $22 million charge in the press release. Tax rate we benefited a little bit coming in at 35.6% versus 36.9% last year in Q2. I believe it is a combination of a couple of discrete items that went our way as well as increasing profitability of some of the foreign operations which have a lower tax rate.

Now for a quick rundown of other topics, one I won't go over is the detail on the balance sheet. You have that in the press release. Depreciation and amortization for the quarter was $185 million and $369 million year-to-date. Balance sheet, as you will see in the press release continues to be strong. I want to make sure you look at it as our AP ratio which is simply accounts payable divided by inventory. ON a reported balance sheet basis it is up 4 percentage points from 100 a year ago to 104%, more than all of the inventories are being funded with receivables.

If you take out, some of those receivables are construction receivables so in fairness it is still up 4% from 83% year ago to 87%. I'm sorry I said receivables. Payable I mean. 87% of our inventories were funded with payables as of Q2 and up from 83% a year ago. Again I think that is simply a reflection of higher sales and therefore slightly higher turns. Average inventory per warehouse at Q2 end was $10.046 million or up $421,000 or 4% from a year ago. If you take out FX that up $421,000 is up only $128,000 per location. No inventory concerns. We came out of the Christmas clean and felt pretty good about getting through that getting rid of seasonal items in a good fashion.

In terms of CapEx, Q2 2009 it was a shade under $300 million. Q2 2010 it was a shade under $200 million. Year-to-date it is a little over $500 million. I would estimate that our fiscal year 2010 CapEx will be slightly lower than last year's figure probably in the $1.0-1.2 billion range but probably closer to $1.0 billion given the fact that a couple of things have been delayed.

The next topic, Costco online, both Costco.com and Costco.ca in Canada seem to be profitable and growing for Q2 and Q3 year-to-date sales and profit in these operations were up over last year. While our average ticket has still come down a little bit we call our average ticket in the mid to high $300's and had been in the mid to low $400's before the economy got hammered. In Q2 year-over-year our traffic was up 8%.

In terms of expansion, as I mentioned previously in Q1 we opened six new locations with no relocations so a net of six. In Q2 we opened two including a relocation so a net of one. We will open tomorrow in Pacoima, California and that will be it for Q3. In Q4 up to eight. With bad luck it could be five. The likely possibility is probably 6 or 7. We are pushing for eight. They all will be under construction. It is a matter of something fall from August to September. So our best guess at this point is 17 new plus the relocations would be 16 net and maybe 15 or 14 but we will see.

In fiscal 2010 assuming the 16 that would be 3% year-end growth and about 3.5% square footage growth. A number some of you like to know at Q2 end total square footage stood at 76, 032,000 square feet.

Lastly, just making a brief comment about stock repurchases. As you know we began buying back in June of 2005 and pretty much ceased in September of 2008 as the economy and ultimately the market was getting hammered. We have spent a total of about $4.8 billion during that time. We bought a little bit in the middle of calendar 2009 and by a little bit I mean 1-2 days worth of purchases. We did during the week of February 8th got back into the market purchasing in aggregate over the five business days of 250,000 shares that week.

Since that week we have not bought leading up to the earnings release and we will look to see what we do after that but we did buy a little in that week of February 8th. The last comment I will make before I turn it back over to the operator, as you know a few weeks ago we made an announcement that Craig Jelinek was named President and Chief Operating Officer effective at the time of the press release in early February. Craig has been around Costco and frankly around many of the people that started Costco since the very late 60’s as he told me. He is 57. He started at [Fed Mart] in ’69. He spent 12 years at [Fed Mart] and then three years from 1981 to 1984 at Lucky Stores. Then he joined Costco shortly thereafter in 1984 initially I believe as a warehouse manager. He has been at Costco for the past 26 years.

He has been for most of that time through 2004 he was in operations. Most recently at that time in 2004 as one of the EVP’s and COO’s and Executive VP’s of operations and basically in charge of about 1/3 of North American operations. At that time in 2004 he and Doug who had at the time been in charge of non-foods merchandising basically switched jobs and for the last six years Craig has been in charge of merchandising until this recent announcement in early February.

Doug who is in his early 50’s, I think 51, started his career pre-Price Club on the sales side with Wilson Sporting Goods selling to Price Club and joined them before the merger in 1993 with Costco. At the time of the merger Doug became head of non-foods merchandising for the combined company. So most of his career had been spent in merchandising up to 1994 at which time Jim had asked Doug and Craig to basically switch jobs a week from that Monday which they have done. So now Doug will now take over all merchandising.

Replacing Doug is a gentleman named John McKay who was one of the two senior VP’s of operations reporting up to Doug when he was running this northern division. That basically is it on that. As we said in the press release also that Jim [Blench] will be around for at least a couple of years so don’t get too excited about not seeing him here.

With that I will just mention that the typical supplemental information packet will be posted on the Costco Investor Relations site later this morning. With that I will turn it over to the operator for questions.

Question and Answer Session

Operator

(Operator Instructions) The first question comes from the line of Deborah Weinswig – Citigroup.

Deborah Weinswig - Citigroup

You addressed it briefly but can you walk us through your share repurchase expectations or how we should think about that going forward?

Richard Galanti

It is kind of like earnings guidance. We are not going to give specific guidance. I think history has shown that for nearly 3.5 years on a pretty much regular basis we bought stock. When we stopped it was as much a sign of the economy and concerns about what was going to happen but probably more importantly the whole issue of liquidity when various types of money market plans including a little over $1 billion of the ones we were invested in were locked up for 3-6 months. That was a little scary. I think certainly we feel comfortable long-term about our business. I don’t see us trying to pick a price or pick an event in time…I wouldn’t expect us to see us announce we did some big accelerated repurchase.

Historically what we did when we were buying when the stock was moving up a little we bought a little less that day and when it was moving down we bought a little more. But generally feeling the underlying value going forward is appropriate. Again, I don’t want to be cute about it but I think what we have said in the past is that we will probably be a buyer of our stock over the long-term. You probably won’t talk about it again until next quarterly earnings release. I think the indication we have started a process here is viewed that we are buying, not not buying at this point. Again, since that week we haven't bought. Again I am not really poised to say what we are going to do in the future other than historically what we have shown that we do.

Deborah Weinswig - Citigroup

As you are aware, I'm sure, BJ's reported earnings this morning. They talked about seeing an increasingly competitive environment. Can you maybe discuss what you are seeing from a competitive standpoint?

Richard Galanti

When you talk about competition there are two things we are always asked about. One is all the supermarket chains over the last many months have talked about a much more promotional and increased competitive market. On top of the fact there had been deflation in a lot of those categories that supermarkets are selling during those many months. Our position hasn't really changed. While certainly the food buyers look at the weekly ads on ground beef and soda pop and the like, those are items that are probably lower than average margin items to begin with for us. We really don't feel a great impact from that. We don't generally price for that.

Within the big box stores, both the direct competitors Sam's and BJ's as well as the indirect ones like Target, Wal-Mart to some extent, Home Depot and Lowes and even the office stores we have not seen any increase in the bar of competition.

Deborah Weinswig - Citigroup

Can you maybe discuss the initial performance of spring seasonal since holiday was obviously quite strong?

Richard Galanti

Again I think as we look at components of February's comps on the soft line side particularly we had some numbers that were very strong. Recognize part of that is it was very weak a year ago but it seemed like starting in September our sundries categories finally saw some 5's, 8's, 10's and 3's on the positive side. I think this past month is the first time we have seen more than a couple of those sub departments in the high teens to mid 20's. I think apparel was more in the mid singles. But it is more of those small electric, house ware, domestics that what I would call mid-priced stuff for the home that is selling pretty darned well.

Maybe a little of that has to do with if you look at our coupon booklets we recognize there is a limit of how many big ticket items are going to sell during the tough economy over the last year. You have seen probably a little bit more marketing effort or merchandising effort towards some of those items. So I think more of it has to do with just what is going on in the industry and a little bit has to do with what we have done.

Deborah Weinswig - Citigroup

We actually had the pleasure of visiting your Danville Club out in California where you have the highest membership renewal rates in the country. You also mentioned that member signups were strong in the quarter. Can you talk about what you are seeing there specifically and is there anything you are doing differently to drive that?

Richard Galanti

Well the renewal rates are pretty constant. Again they have been in that mid 87.3-87.4 range for awhile now. On the signups in talking to Paul Latham yesterday who is VP of marketing, it is a lot of just blocking and tackling. What I find frankly is what we call our marketing people in the warehouse which are a combination of that membership renewal desk and the membership desk as well as the refund desk, some months or weeks they are focusing on executive memberships and sometimes they are going out and talking to small businesses and medium sized business about new member initiatives. So my guess is a little bit of it has to do with the fact of where did we place our bets this quarter. Overall, I have to believe a little of it is just the press that clubs are getting in general and that we get as it relates to this is the place to save. There is nothing magic we are doing other than blocking and tackling.

Deborah Weinswig - Citigroup

Do you find new member signups have been disproportionately executive members or is it pretty representative of what the base already looks like?

Richard Galanti

It is disproportionate but not majority. If you go back to a couple of years ago for every new member that signed up whether as a new warehouse in the U.S. or an existing warehouse our success rate of getting them to initially sign up as an executive member was something in the low 10's. 10-12 I believe. In the last year I believe it has gone up to the low 20's. Again if you talk to Paul and his people a lot of it has to do with what I will call "duh." They are doing more stuff in the warehouse, at the desk and getting our message down a little bit better. Recognizing that we have just regular hourly employees out there. We don't have trained marketing people. I think we have done a little better job of communicating to our members why they should.

Operator

The next question comes from the line of Charles Grom - J.P. Morgan.

Charles Grom - J.P. Morgan

I don't ever recall so much concern about earnings guidance for you in the past. I was wondering relative to your initial expectations how did the quarter wind up coming in? Was it better, in line or did you miss what you originally set out to do?

Richard Galanti

I am looking at our in-house counsel. If you look at our original budget for the beginning of the year keep in mind this is last August I think we are pretty darned close to where we thought we were going to be. We are satisfied with the numbers.

Charles Grom - J.P. Morgan

On the margins, the 54 bips, can you walk through the four key categories just by category for us? How it actually broke out?

Richard Galanti

Again, I already mentioned the food and sundries one which again is the biggest but then if you look at food and sundries was above 50. Hard lines was around ¼. Soft lines was around ¾ of a percent and fresh food was about 50. So you add all those up per weighted average based on sales and you get to that mid 50 number.

Charles Grom - J.P. Morgan

Just to follow-up the gas mix to get down to the 15 is the plus? So that is 39 basis points? Is that right? You gave a lot of numbers. I am just trying to make sure I got it right. Or was it 24?

Richard Galanti

The 24 is the gas mix. There is other things. There is the other ancillary business margins. There is the hit which was a lot of it from executive membership. There was the hit year-over-year comparison to LIFO which was 4. So there are a few other things as well.

Charles Grom - J.P. Morgan

I know you don’t want to talk about the next couple of quarters but can you give us a little bit of a sense of what you are thinking on gross profit and SG&A given that every basis point tends to move the needle a lot?

Richard Galanti

I would love to but I can't. I am not trying to be coy. Again I think the trend at least from the last few months has been promising. The fact there is less deflation on the food and sundries side virtually about flat, no inflation and no deflation for the first time in awhile in February. We still have deflation on the electronics side and the like. The fact that the dollar is weaker helps, again I am not a predictor of currency rates but if they stay where they are now we are still being helped by that each quarter. We don't have the freebie of the big aggressive pricing we did last year versus now. I think we have lost a little in gas last year in the quarter. Then in Q4 last year. So again that is going to be help and then a challenge. Depending on what happens it is so hard to predict what gas profits are week to week.

I think at the end of the day we are cautiously optimistic but we will have to wait and see.

Charles Grom - J.P. Morgan

My last question is with regard to Sam's closing their ten stores have you done an analysis of what you think that can do to your profitability as they close those stores?

Richard Galanti

Yes. I think those ten locations I think 7 or 8 of them were directly near Costco locations. I believe it is 8. I believe those 8 impacted 12 Costco's. In some cases or a few cases there is one on both sides of that Sam's. The big impact is margin. That impact is as you might guess with Jim at the helm here is not going to change immediately overnight. But historically when we look at what I will call competitive locations in the U.S. versus non-competitive you can see as much as 1-2 percentage points of gross margin difference which all falls down to the bottom line. So, it can be meaningful in those locations.

We don’t expect a big sales pickup. As you might expect the ones they are closing aren’t their best units. They are based on our analysis of them the lowest volume units. We will get a little pickup in sales, a gradual pick up and probably not the whole amount in margin because that is not what we do. But as someone said once it is like Chicken Soup, it can’t hurt and it probably helps you a little bit over the next 18 months as did the six closures in Canada that Sam’s did helped us for 12-18 months. My guess is at the end of that we get 75% of what you and I might get.

Operator

The next question comes from the line of Mark Miller - William Blair & Company.

Mark Miller - William Blair & Company

As the SG&A hits become a smaller negative and also I know you have done some work on sustainability which might be helping on the cost side, what do you think that does to the underlying comp sales leverage point?

Richard Galanti

It is a guess. Remember a few guesses is based on some things that everybody is doing including us and trying to be a little tougher on ourselves. And excluding healthcare maybe the breaking point from a 4.5 estimate to a 3.5. Who knows. We will have to see. I probably will stick to that. We haven’t done any type of regression analysis on it of late.

Mark Miller - William Blair & Company

Can you talk about when you started the new employee wage contract and should we think about that as a factor going forward? I guess I am thinking with deflation maybe that is a potentially better term?

Richard Galanti

It is effective March 2010 for the upcoming three years. The big item typically is what happens, there are three new columns if you will for hourly progression. It really doesn't impact new employees until they get top of scale. About 55% of our U.S. hourly employees are top of scale. There is not a big difference between what they are going to get each year going forward for the next three years versus what they have gotten in the past three years. We looked and discussed around and around at a couple of different off-site meetings. At the end of the day there is not a big change.

The view is that this is the time particularly in the first year of it is the time that our employees need it the most. As you would expect that is what we did. Again, I think the challenges of some of the comps we had over the last 1.5 years have started to abate both economy, not that it is getting better tomorrow but we certainly have seen some benefit and the whole issue of deflation and inflation. The feeling is we will be able to take care of that. Not a big change in terms of any major savings there other than savings with sales [inaudible].

Mark Miller - William Blair & Company

If you can give us your updated thoughts on potential membership fee increase and I am sure you are going to be looking at renewals which look healthy. If you could maybe talk about the main things we should be watching to see when the fee might be coming up?

Richard Galanti

There is no plan yet. History has shown about every five or so years we have done it on the base fee from 25 incrementally, $25 has climbed up to $50 now. One of the issues is 35% of our U.S. operation is California and California the statute says that membership fees are not sales taxable as long as the fee is diminimous. Diminimous is currently defined at $50. In their statutes they calibrate it every fifth year and that calibration calculation subject to change, I mean the state of California can do anything to change the current limit. The current way it works would be in January of 2011 that number would be reset based on the prior diminimous amount plus the California CPI over the next five year period ending in January of 2011.

Now in January of 2006 when it was calibrated up to $50 we did not the next day go out and raise it. I believe we didn't raise it until May or June of that year. My guess, we have never shown a shyness to increasing the fee as we feel that we have got more than that $5 increase in value to our members. That is our conviction. I guess the good news is the economy went into a tailspin a year and a quarter ago. I am kind of glad this calibration didn't occur then because I don't think anybody had an appetite even if we felt confident we could. I can't say when it will be. Will we raise it again? My guess would be yes.

Would it assume there is this calibration change in California? My sense would be yes. Will it be in January right after that? My assumption would be no. It would be sometime over the next year. That is a probability but again we have not discussed it. [normally] discuss what we would do at the $100 executive membership number. In the past two $5 increases from $40 to $45 and $45 to $50 we have chosen to leave the $100 alone and I think that one of the reasons you see this strong, continuing conversion and increased penetration of those members because that break even has gotten smaller each time when the delta was $60, then $55 and now $50.

But I think again we would look at that as well. Again I am not trying to be coy. History shows that we do and at some point we probably will. We have been asked, I know, we have all been asked often what is the impact of one of our competitors it will be a big year difference with them. We really not to be arrogant about it but we have really never looked at that difference. In the face of a higher delta between our fee and our competitors we have done it in the past successfully. I don't see that as a big concern.

Operator

The next question comes from the line of Adrianne Shapira - Goldman Sachs.

Adrianne Shapira - Goldman Sachs

Maybe just stepping back you clearly had a lot of headwinds last year that seem to be turning into tailwinds whether FX, deflation, gas and maybe your thoughts in terms of the slope of these lifts? Where they were and how steep you thought they were at the start of the year, where you think they are now. Clearly they are all positives but share in terms of degrees of positive.

Richard Galanti

From eight degrees to 40 degrees. Just kidding. I would guess a long standing slope clearly is healthcare. Again, I am hopeful part of that increase which had to do with just increased penetration of number of employees covered has peaked and is not going to impact us additionally. I guess so much of it depends on what is going to be the rate of underlying comp sales growth, FX, gasoline, inflation and deflation. The trend over the last 4-5 months has been good. The fact that in February we essentially saw no inflation or deflation compared to some deflation in the prior months on the food sundries side is a positive.

I think if Jim were here he would say margins aren't an issue. We have shown the ability to improve margins and I think we will continue to be able to do that in a controlled way. If Jim were here I would say a very controlled way. On the expense side frankly I think we have done a decent job on payroll and on central and on everything but the second biggest nut and that is healthcare. The bonus thing, it is really a mid-year deal because I am not concerned about that. Hopefully we will always accrue that every year and it will be a flat comparison year-over-year. This is the quarter that it hit us.

The same thing, I think the worker's comp was a little bit of an increase and a bigger piece which was just the left of the actuarial draw of being a bring back in Q2 of last year and a positive this year. Frankly any bring backs last year the quarter was so crappy we didn't talk about a lot of little things.

Adrianne Shapira - Goldman Sachs

Drilling down then on deflation as Jim says margins aren't the issue. It sounds like deflation is abating and as you describe a pretty rational competitive environment, I think we all know philosophically you are sort of the first to lower. Is the flip also true that you are the last to raise?

Phil Sewell

Absolutely. Last to raise sometimes is three days or a week. We are not going…if a cost of an item is going up and it is a high volume item like toilet paper or whatever it is really the commodities because even in things like paper goods, big volume we run into 6, 12 and 24 month deals with these vendors and they have locked in certain pricing too in order to be able to commit to us. So some of this is going to happen over time. Really it goes down to a lot of commodities and fresh food which of course changes daily and weekly. If the price of something goes up we reflect it pretty quickly. Quickly might be two weeks instead of one week later.

Operator

The next question comes from the line of Dan Binder – Jefferies & Co.

Dan Binder – Jefferies & Co.

A question on the SG&A again, not to beat a dead horse, but if you look at first quarter you didn't really have a big FX hit there and your SG&A growth was probably I think just under 8%. Recognizing in any given quarter there may be some one-off items and there may be have been this quarter, I guess it sounds like you are not expecting much in terms of one-off items in the next couple of quarters. So does that mean the SG&A dollar growth should look more similar to Q1 including FX?

Richard Galanti

Last year wasn't the greatest year. In Q3 of last year we also had a bonus bring back and I am hopeful this year we won't so that will be a slight negative. I don't think it will be as big of a negative as this year. I don't think again if you look at the luck of the actuarial draw more to the historical prior year stuff than current year my guess is that is not likely to happen. It could but I am not guessing that is going to happen. The healthcare is not going to be as big of an increase but it is not going to be wonderful either. Every month when we see the statistics in terms of number of incidents or number of high cost incidents just when you are starting to feel a little better one month the next month it is a little higher.

Again, last year in the second half of the year when healthcare costs were up in the low to mid 20’s versus it had been up in the 10-15 range before that. I know we are not seeing this big increase in employees covered. That has been anniversaried now. So the answer is a better yes. Is it wonderful? No.

Dan Binder – Jefferies & Co.

In the electronics business a separate topic, I think one or two calls ago you were thinking deflation in electronics might start to ease. We heard from Wal-Mart recently they thought it was easing a bit. In terms of your outlook at this point could you update us on what you are thinking for TVs and electronics broadly from a deflation standpoint and how you think that may impact you this year for the remainder of the year?

Phil Sewell

Actually yes. I will talk while I look. In the month of February TV unit sales were down very slightly and dollar sales were down a little more than that. So still a little deflation but less than 5% deflation. What we are seeing on the TV side a little of that was shortages. All of a sudden there is a pickup in world demand. I think last month was the first month ever that more TVs were sold in China than in America ever. Between flat screen demand in Europe and China our head merchant in electronics was talking about the fact that I forget what size it was but the underlying costs of the panel itself in the U.S. gets something like $125 and in Europe and China is getting $200. So there are big differences so more stuff is going that way.

So we actually had a couple of supplier shortages that I believe are in the process of fixing themselves. Last year the other thing was and this is when I talked earlier about the couponing, it was about a year ago we were very strong in some of the multi-vendor mailers. Over the last year the success of some of those items have come down as everybody has televisions and the price points have come down. What has been successful is look at the [MDMs] it is getting people in the door with basic items.

I think in terms, we think there is still plenty of demand in unit sales. I think the price points have pretty much flattened out but we are still comparing against the craziness of that tail end of that year-end period where we were seeing that 40-50% unit increases.

Dan Binder – Jefferies & Co.

On the couponing booklets as you look out over the next quarter or two whether it is for TVs or just broadly the coupon book that you send out are they from a promotional standpoint product discount savings, is it a similar posture as a year ago?

Phil Sewell

I think the posture on our [MDMs] going forward is similar to a year ago. I think the motivation is to get more non-food and bigger ticket items in there. Bigger ticket means going from medium to a little bit bigger than medium. Not all giant like it was during the gravy days.

Operator

The next question comes from the line of Robert Drbul - Barclays Capital.

Robert Drbul - Barclays Capital

Can you give us an update on the private label penetration and I guess sort of the lateral piece of that any reads you feel into the consumer you are seeing? The second question I was wondering is if you could give us any sort of early learning's or perspective from the Manhattan store and how that is going?

Richard Galanti

What was the first question? You said Manhattan. Oh private label. I think the trends continue. We are approaching 20. I am not sure if we are at 20 yet. We are at 20 now. So it is growing. The big delta year-over-year in sales penetration we saw is continuing. Not as dramatic as it was 6-9 months ago but still increasing penetration. We have several items on the food and sundry side that will be coming out this fall which I can't talk about yet. Again, nothing earth shattering that is going to take the 20% number to 25 but it is all additive and basically there is not a whole lot out there that is sacrosanct and we want to sell both the best brands and the best [inaudible] alternatives.

On Manhattan, at the end of the day we are doing fine. We are probably doing 80-90% of what we originally thought sales wise. What we are finding is that during the week we get a lot of local neighborhood traffic. What you don't find is people on their way home from work saying hey let's go drive over to Costco on the way home from work because they don't do that. We see a big upper east side and upper west side traffic on weekends. We get a lot of grief from the parking lot because it costs $4. It is not our parking lot by the way. It is what it is. Overall I think we have a little press locally in Manhattan because of the layoffs that happened right after Christmas. We always have seasonal layoffs afterwards. In addition to having opened this on November 11th we probably over expected and then came in a little under so the layoffs were a little bigger than normal. Nothing that was as news worthy as it appeared in the local papers there.

We want to get as many people back to work and as quickly as possible. It has continued to grow. We are seeing the bodega, the small business improve. Again, I think it is going to be a great location. I think we have a lot of questions about it because of the local news of 160 layoffs or whatever.

Operator

The next question comes from the line of Analyst for Mark Wiltamuth - Morgan Stanley.

Analyst for Mark Wiltamuth - Morgan Stanley

One more time, I am sorry, on the SG&A line if you look at year-over-year growth excluding the $22 million charge that is about 11%, what would it be without the FX impact?

Richard Galanti

About 8.

Analyst for Mark Wiltamuth - Morgan Stanley

So going forward that could moderate a bit as you lap the health or is that incorrect?

Richard Galanti

Yes it could. We are hopeful that it will and we will let you know.

Analyst for Mark Wiltamuth - Morgan Stanley

On the $22 million charge you took this quarter was that a cumulative charge for the entire year? Will you continue to accrue this? Also…

Richard Galanti

It is a cumulative charge that will grow as the company grows. So this is rough numbers but if the company was 10% bigger in people incrementally over that two year period there would be another $2-3 million charge hit to the P&L but not a $20 million charge. That was a cumulative charge.

Analyst for Mark Wiltamuth - Morgan Stanley

That was just the new decision you decided to start paying for unused vacation? What was the decision behind the timing of it? Is it you feel better about your business?

Richard Galanti

The timing had more to do with the fact we had already delved into this in certain states based on certain state laws and we felt it was the right thing to do. It is tied into the March 10 new employee agreement. We got a lot of questions on it from employees. As we go through really a one-year process leading up to the new employee agreement you get all kinds of requests from open toe shoes and wearing shorts to how different holidays are handled. We have been getting questions on it. We looked at it and what happens is you get employees that have moved and in one state they got it and in another state they didn't. It was just the right thing to do.

Operator

The next question comes from the line of Colin McGranahan – Sanford C. Bernstein & Co.

Colin McGranahan – Sanford C. Bernstein & Co.

Going back to gross margin here and this may be kind of an odd way of thinking about it but if the core gross margins were up I think you said 54 basis points, in the prior year core margins were down 57 basis points because of obviously the mark downs and the sharp pricing. So you didn't quite get back all the margin you lost last year versus the first quarter I think the core margins were up 11. The prior year they were down 2. So you kind of had a net positive. If you go back a few quarters you have kind of been seeing that core piece of the merchandise margin growing and up. Adjusting for the easy compare last year maybe it was down slightly. I would have thought with mix and some of the better soft line category numbers the mix would have been a little more positive. Is there anything else going on there that maybe those core merchandise margins weren't up as much as I thought they should have been?

Richard Galanti

There are several things. First of all last year you whereas this year gas helps your margin or hurts your margin, last year it helped your margins. Last year is when you had huge deflation in gas.

Colin McGranahan – Sanford C. Bernstein & Co.

So we have 50 basis points of positive benefit on gas but you still had 57 basis points of core kind of X gas right?

Unidentified Speaker

I will have to look at the numbers but I believe the 57 includes the benefit we actually got last year because of the deflation in gas.

Richard Galanti

We will have to look. When we looked at the numbers we felt it was still a positive. Let us look at it. We would be happy to discuss it. There are no secrets here.

Colin McGranahan – Sanford C. Bernstein & Co.

The other way you could look at that it is obvious it is a sub category and you went through by each of your sub categories. Did you feel like you got back all of the lost mark down pressure from last year at the sub category level?

Richard Galanti

Yes because virtually all of that, virtually all of the aggressive pricing I talked about was commodity related in the food sundries side. That number without that roughly $30 million of mark downs was still plus 13 on light sales.

Colin McGranahan – Sanford C. Bernstein & Co.

Bringing the horse out to kick him once more in SG&A have you disclosed or could you disclose what percentage of the SG&A is healthcare? So if we kind of adjust the growth rate for that as you are anniversarying it we can see what the X currency growth rate on SG&A might do?

Richard Galanti

I don't have it in front of me. If you think about last year in 2009 it was roughly $700 million for healthcare costs.

Colin McGranahan – Sanford C. Bernstein & Co.

For the full year?

Richard Galanti

For the full year on sales of $70 billion.

Colin McGranahan – Sanford C. Bernstein & Co.

On the FX contract is that just currency swaps you are saying had been in the operations live SG&A. Was that ever particularly material?

Richard Galanti

It actually is in the margin line. As an example, let's use Canada as an example. Canada buys some of their goods in U.S. dollars and there are terms on those that could be 10 days or 7 days or it could be 60 days. Based on their weighted average of daily expectations of U.S. dollars out they convert some of their Canadian sales receipts into U.S. dollars. All it is when you mark that to market at the end of a month or the end of a fiscal period we tend to err subject to giant changes in currencies we tend historically to err to our benefit a little bit. So there is always a few million pick up frankly. Historically that has been in margin. Now because of some accountants smarter than me the new rules are it is down in interest income and other. I am sure there is some FASB or APB or some other acronym out there that is making you do it this way but rather than reclassify stuff from prior years it is what it is. It is a handful of millions. Not a heck of a lot.

Colin McGranahan – Sanford C. Bernstein & Co.

So in periods of rapid currency moves you typically had a benefit?

Richard Galanti

Yes.

Colin McGranahan – Sanford C. Bernstein & Co.

Or strengthening?

Richard Galanti

We tend to mitigate the impact when it is the four week fiscal period that happens to be quarter end. To be a little more assertive in the two months leading up to it knowing that the bills will be paid and we won't have these contracts in place at quarter end.

Operator

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

Peter Benedict – Robert W. Baird

If you look to the core average ticket excluding gas and FX it was down about 1.5% in the second quarter but you said it was flat I think in February. As we look to the back half of the year is that something we should expect to be positive year-over-year?

Richard Galanti

It depends. The trend is good and we are hopeful. Your guess is as good as mine. Clearly from a merchandising standpoint we are aggressive. We are out there. The buyers are buying and they are told to be aggressive on getting stuff and don’t be meek on bringing in bigger ticket items. Our model allows us to be a little more aggressive. So hopefully yes but you never know until it is there.

Unidentified Speaker

I am hopeful that some of this price deflation abating that will help as well. The FX and gas will be what it will be but for it to improve a little bit barring the same traffic levels we are going to have to see a little bit of an improvement there in the core comp for that to happen.

Peter Benedict – Robert W. Baird

Shifting over to membership fee income, that 5% excluding FX growth rate you saw in the second quarter any reason why that isn’t sustainable in the back half of the year?

Richard Galanti

Well, other than it is our first time in awhile. When you talk to the marketing guys the membership revenue increased. Again I think the answer is it should be but it is always something.

Peter Benedict – Robert W. Baird

Could you talk a little bit about the trends you are seeing in California? Excluding the gas, take out the gas business what has been going on in California?

Richard Galanti

It is actually doing pretty good. I mean the trend in California if I looked at the last 3-4 months it has been gradually improving.

Peter Benedict – Robert W. Baird

Is it positive excluding gas or still slightly negative?

Richard Galanti

Slightly positive in February.

Operator

The next question comes from the line of Laura Champine – Cowen & Company.

Laura Champine – Cowen & Company

Why did you make the change that cost the 12 basis points in SG&A in the quarter, the change in benefits? What was the driver there?

Richard Galanti

The driver was in about 30% of our employees in the U.S. in certain states it was something that upon termination they would get paid. Up to three days. Some fraction of three days pay. For the other 70% they weren't. We were getting questions on it. We have always done it that way but as each state changed the rules we just thought it was the right thing to do. Also with the employee agreement so it was a good time to tie it in.

Operator

The next question comes from the line of Sandra [Barker] – Montage & Caldwell.

Sandra [Barker] – Montage & Caldwell

I will ask about real estate what you are seeing in terms of opportunities there. How do you think about the pipeline of opportunities going forward?

Richard Galanti

There is more opportunities. We are not getting back into it. It was about a year ago when we halted anything that wasn't signed to renegotiate. I know we are talking to and continue to talk to the shopping center operators as well as banks in the case of some foreclosed properties. We are ramping up some of our international a little bit. Our success in Asia is an example and Australia recognizing we have one unit for a few months there but ramping up doesn't mean we are going to go from one in Australia to ten in two years. It means instead of doing three in three years total we will do hopefully five or six. I would say active. The hope is we did a net of 16 last year and something around that number this year. This is the year that number could get back into the low 20's in 2011 and 2012 and the high 20's in 2013 and 2014. We have been wrong before but we do have a lot of irons in the fire there. We have two coming in your state.

Operator

At this time there are no further questions.

Richard Galanti

Thank you everyone. Have a good day.

Operator

Thank you. This concludes today's conference. You may now disconnect.