Costco Wholesale Corporation (NASDAQ:COST) F1Q2011 Earnings Conference Call December 8, 2010 11:00 AM ET

Executives

Richard Galanti – EVP and CFO

Analysts

Tina Wang [ph] – Citigroup

Charles Grom – JPMorgan

Adrianne Shapira – Goldman Sachs & Co.

Mark Wiltamuth - Morgan Stanley

Mark Miller – William Blair & Company

Bob Drbul – Barclays Capital

Rob [ph] – Cowen and Company

Mike Montani– ISI

Neil Currie – UBS

Operator

Good morning. My name is Debbie and I will be your conference operator today. At this time, I would like to welcome everyone to the Costco first quarter results. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. (Operator Instructions). Thank you.

Mr. Richard Galanti, Chief Financial Officer, please go ahead.

Richard Galanti

Thank you Debbie. Good morning to everyone. This morning's press release reviewed our first quarter fiscal 2011 operating results for 12-weeks that ended November 21.

As with every conference call, I'll start by stating that the discussions we are having will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, and that these statements involve risks and uncertainties that may cause actual events, results, and/or performance to differ materially from those indicated by such statements.

The risks and uncertainties include, but are not limited to, those outlined in today's call, as well as other risks identified from time to time in the company's public statements and reports filed with the SEC.

To begin with, our 12-week first quarter operating results. For the quarter, earnings per share came in at $0.71 a share, an 18% increase over last year first quarter earnings per share of $0.60.

Three items I'll quickly note here. First, last year first quarter we enjoyed very strong gasoline profits. As many of you know when gasoline prices are flat or falling, Costco's gasoline operations can be quite profitable and when prices are rising, they can be less profitable. This year’s first quarter gasoline operations were profitable but less profitable than a year ago to the tune of a little over $0.03 a share.

Second, you'll note that our income tax rate is almost two-percentage point’s lower year-over-year, 36.1% last year in the first quarter compared to 34.2% tax rate this year. In the first quarter of this year, one of our foreign operations received a tax refund in connection with a tax loss in 2007. At that time, no tax benefit had been recorded due to the uncertainty of the refund claim. During the first quarter of '11 here, the issue was resolved and the refund issued. It reduced our first quarter 2011 provision for income taxes by approximately $9.6 million. The impact to our first quarter EPS however was a benefit of about $0.01 not $0.02. That's because half of it or $4.8 million, half of that benefit, half of the 9.6 is backed up on the non controlling interest line down below.

So again, the two things I mentioned here, a little over $0.03 benefit from gas and a detriment of gas year-over-year and a benefit of about a penny here due to this unusual tax item.

And the third item, as I mentioned in our fiscal year end conference call, effective the start of fiscal '11 our current fiscal year, we have begun consolidating the results of the operations of our Mexico joint venture. Historically, these operations were treated as an equity method investment, thus we only reported our 50% share of the joint ventures net income within the non-operating interest and other income line item on our income statement.

As of the beginning of this fiscal year, back in September we were required to adopt a new accounting method, which makes it appropriate to fully consolidate the cost from our Mexico joint venture to our statements. In effect, it adds approximately 2 to 3% in top line sales, assets and liabilities. One hundred percent of the ventures financial statements are now included in our P&L, balance sheet and cash flow and then the 50% portion held by our joint venture partner is backed out at the bottom of our income statement to offset it. That's in the line item called net income attributable to non controlling interests. Such that is no effective cost on the bottom line or earnings per share.

It does impact our discussion with gross margin, SG&A and earnings basis points and I'll discuss that as we go along here in this conference.

In terms of sales for the quarter, 12-week reported comparable sales figures for first quarter showed a 7% increase, 5% in the U.S. and 14% internationally. Excluding gas price changes and the impact of FX, the 5% reported U.S. comp would actually be four in the fiscal first quarter and the 14% international comp reported would be a 10 in local currencies. And overall, the 7% that we reported for a total company comp would remain, would be at 5%.

The comp figures by the way do include Mexico in both years of calculations so that it is an (inaudible) comparison as relates to that.

Other topics of interest I will review are opening activities and plans. We opened a total of eight new locations during Q1, which ended November 21. Seven of these eight openings were in the U.S., including one new business center and the eighth location was in Alberta, Canada.

For all of fiscal 2011, our current plan is 27 units, net new locations. Two of those are new relocations, 15 of which would be in the U.S. And, as I meneioned two relocation.

Since Q1 end on November 21, we opened two new locations. One in Minnesota and one in the State of Washington so we now operate 582 locations around the world.

I will also touch on our line results, our membership trends, some discussion about margins, SG&A of course, stock repurchase activities and as you know from last quarter, we include in our press release our balance sheets so we'll go through that.

Okay, the discussion of our results, very briefly, sales for the quarter were 18.8 billion, up 11% from last years 16.9 billion. If you exclude Mexico, because this is not apples to apples, it's included in the share not last year, without these sales the 11% increase would have been 8% in total basis. Our reported comp basis, Q1 comps as I mentioned were 7%, excluding gas price changes and FX were up 5%. Again, on a comparable basis those numbers include Mexico for both years. For the quarter, our 7% reported comps sales number was a combination of an average transaction increase of a little over 2% for the quarter, an average frequency increase of 5% for the quarter. So continuing very strong frequency now going on an almost complete second year at relatively strong frequency, shopper frequency numbers. I might mention that the average transaction increase of 2%, that figure would be slightly positive if you exclude gas inflation and the FX issues.

In terms of cannibalization, it continues not to be a big issue, about 35 basis points in the fiscal quarter, not that different from past months and quarters.

In terms of sales comparisons by geographic region, keep in mind both for the quarter and the month that we reported, the month of November, which we reported last week, the combination of FX and gas is right around 200, about two percentage points. FX being 110 to 130 basis points and gas being 65 to 80 basis points. Geographically, Northwest has really been consistent for the past several fiscal quarters continuing in the mid single positive range, positive percentage range. California has vended upwards overall over the last several quarters and months, particularly in November it showed its strongest recent month.

The rest of the United States, Northeast in the low to mid positive singles. Southeast in the mid to high singles positive and Midwest in the high singles. In every U.S. region except the Northwest where we had very, we had freezing snow and ice for two or three days leading up the Monday through Wednesday before Thanksgiving, November was the best sales comp month for the three months of September and October and November. And even in Northwest, even in November was impacted by that last week of November. November overall for the Midwest was in the mid singles.

Internationally local currencies, we're doing quite well. In terms of local currencies, U.K. is the weakest foreign region, slightly positive. All other countries are fine in the local currencies, in the plus 10 to plus 35% range of local currencies.

In terms of merchandise categories for the quarter, again that's mostly September, October and the first three weeks of November, within Food and Sundries, comps were in the mid-single digits positive, with candy, deli and refrigerated being relative standouts. We're starting to see the beginning of some inflationary pressures in some of the food related areas but not a lot of impact in our Q1 figures. More important to November, I think in going forward we'll see some inflationary pressures. Our Hardlines sales showed slightly positive comps overall with mid to high-single digit negative comps in electronics, offset by sales strength in tires and automotive and sporting goods and office supplies and hardware.

Within the positive Softlines comps, which are actually in the low positive double-digits, housewares, jewelry and special events were particular standouts but many of the other departments, small appliances, domestics, home furnishings, up nicely as well.

Media continues to be the struggling department. No surprise, starting with relative industry weakness in CD's a few years back and DVD's plus with the pressure of other forms of distributing those items.

Fresh Foods up in the very high singles overall. Standouts in fresh foods continue to be both meat, beef and produce but also categories including bakery and deli were up as well. Again, we are seeing some inflationary pressures impacting fresh food prices. Our buyers in that area estimating that in Q1 that rpresented perhaps up to 3% of inflationary pressures.

Anecdotally, steak prices up year-over-year over 15% per pound. The entire, what they call the beef complex which is everything, both imported, exported and all parts of beef was up about 4% on average. So steaks, which is what our strength is, has had the most inflationary pressure. Poultry not up yet a lot but coming. Overall beef, chicken, pork, the estimates are that you'd expect over the next six months to see perhaps inflation in the 5 to 10% range.

On the bakery side, soybeans and soy oil were up 50 to 60% year-over-year. Sugar up 20%. Butter up 5% and wheat up 30% year-over-year. So the raw materials in Bakery are good and Bakery we've been trying to hold the prices as long as we can so we've actually incurred lower margins in Q1 in the Bakery. Notwithstanding that the strength in margins in meat and produce more than offset that so overall fresh foods margins in Q1 that were up year-over-year.

Moving on to the line items of income statement. Membership, 415.8 million or 2.21% in the first quarter. That's up 10.2% in dollars and down two basis points, up about $38 million overall. We consider that a good showing.

Strong renewal rates, we've actually cracked the 88% number and continue to see increasing penetration of the Executive Membership. Our new membership sign-ups in Q1 companywide were up 1% year-over-year. Actually, stronger in the U.S. because, if you recall in the fall of '09, Q4 of '09, we had incredible sign-ups in some of these new Asian/Australian markets that we opened in and very strong sign-ups going into Q1 of '10. So we're comparing against that this year but nonetheless companywide up a little over half of about 1%.

In terms of numbers of members of Q1, I'll just give you two columns. At year-end, and Q1 end, Gold Star members 22.5 million at year end back in August and 23.5 million now. Primary business, 5.8 and 6.2 at year-end, first quarter end 6.2. Business add on 3.3 and 3.6 so all totaled 31.6 million member households as of Q4 end and 33.3 million as of Q1 end. Including spouse cards, 58 million cardholders at year end and 61.2 at Q1 end, I would make a note that the 58.0 at year end would have 60.8 with Mexico included, so still an increase overall.

At November 21, first quarter end, paid Executive Members 10.76 million, an increase of just under 300,000 or 3% since 12-weeks earlier at fiscal year end. So we're still either converting or signing up as new 24,000 per week, numbers per week as Executive Members. Executive Members represent about a third of our member base at a little over two-thirds of our sales, certainly an important number for Costco.

In terms of renewal rates, as I mentioned they've strengthened, for the quarter they ended up at 88.2% versus 87.7% at fiscal year-end. Remember these renewal rates include fiscal U.S. and Canada, which totaled just under 90% of our total company. The newer regions were relatively newer locations we start off with a lower renewal rate but overall those two have trended upward. all

Going down the gross margin line, year-over-year we were up nine basis points, 10.97 versus a 10.88. And again as I just jot down three columns here, core merchandising would be line item one, ancillary businesses, line item two, 2% reward, line item three, LIFO, line item four. Total with line item five, and I'll add two new line items, six and seven, would be Mexico, would be the impact of Mexico and then the company without Mexico, just doing that to share with you how much of the nine related to Mexico. Mexico works at a little higher margin and works on a little lower SG&A so that impacts both of those figures for our company.

All totaled, gain with three line columns, fiscal '10 overall, Q4 '10, Q1 '11, just going across our core merchandising was up six basis points year-over-year for the whole fiscal '10, up five basis points for the fourth quarter and up 19 for Q1. Ancillary, plus three, plus eight and minus nine.

2% reward; this just simply reflects the increasing penetration of the executive sales and associated rewards with that. A minus two basis points in all of '10, minus one in Q4 and minus one in Q1 of '11. LIFO was at minus five in all of fiscal '10, minus eight basis points in Q4 and not an issue in Q1, zero.

And totaling plus two basis points, so in all of fiscal '10 we had gross reported gross margin at two basis points higher year-over-year. Q4, plus four basis points and Q1, plus nine.

Now the only thing in the last two line items will be in the right most column of Q1. Mexico represented plus three basis points so without Mexico it would be plus six for the company.

Now as you can see our overall reported margin was higher by nine or six, excluding Mexico and core was up 19. Our lower margin gas business rpresented 8% of sales in Q1 '10 and a little under 9% in Q1 '11. As well our gross margin gas was lower this year in Q1 than a year ago so a combination of a little higher sales penetration and a little over our margin on the business on R&A is quite a little lower margin than the core business.

This resulted in all ancillary businesses being hit by nine basis points within that number to the whole company. Within that number gas was actually 15 and all the other ancillary businesses were six and positive. So that the impact for the ancillary and most particular, gas.

So our gross margins in our core merchandising business, Food and Sundries, Hardlines, Softlines, Fresh Foods were higher year-over-year in Q1 by 22 basis points. Its slightly lower aggregate sales penetration year-over-year caused it to be up 19 basis points in this matrix.

As I mentioned, all four major departments, Food and Sundries, Hardlines, Softlines and Fresh Foods were up year-over-year ranging from as little as up 12 basis points to as much as up 44 basis points. In some margins of the first quarter were fine. And again, Mexico represented three of the nine basis points to the company overall.

Moving onto SG&A, our SG&A percentage in the first quarter was better by 19 basis points, coming in at 10.31 this year versus a 10.50% last year. Again, we will do three columns and seven line items. The line items are Operations, second one is central, third one is equity or stock options, fourth is quarterly adjustments, fifth is total and then six and seven is simply Mexico and without Mexico. So what is the impact of Mexico on these numbers?

So again going across Q4 '10, I switched these around so let's do fiscal year '10 is the first column, Q4 '10 and then Q1 '11 so going across operations, plus two basis points for the fiscal year, plus nine for the quarter and plus 17 for the first quarter. Plus means better or lower.

Central; plus one, minus one and plus one. Equity, zero, zero and plus one. Again, pluses are better or lower. Quarterly adjustments, plus seven, plus four and zero.

So total reported SG&A year-over-year for all of fiscal '10 was plus 10. For Q4 was plus 12 and for Q1 was plus 19. Now down below in the right most column, Mexico's impact on these numbers was plus seven, meaning that it has a higher impact on SG&A because it's lower SG&A than margins on the upside. And without Mexico therefore, we were 12.

Now in terms of inventory of SG&A, again SG&A was lower by 19. Seven basis points of that was Mexico. Mexico operates on a lower SG&A percentage, mostly lower payroll and benefits. Frankly, most controllable expenses as well as a lower option to see cost in those cases were we have a rent factor.

In terms of our core operations I might add our payroll percentage was better or lower year-over-year by 15 basis points. Somewhat offset by higher benefits expenses. I might add that the rate of dollar increases in our healthcare costs, while still increasing

at a rate higher than top line sales is subsiding a bit.

Our central expense was better year-over-year by a basis point. Central payroll again was actually better, lower by a basis point. Again, not the case with healthcare costs.

Overall, SG&A performance we think was quite good. We're benefiting, we believe from both a little stronger sales levels and I feel an increased focus on expense control, which I've talked about in each of the last fiscal quarters.

Next on the income statement; preopening expense. Preopening expense last year was $10.8 million and this year, $11.9 million so both years' six basis points, about a million higher. No big surprise, last year we opened six openings in Q1. This year, eight.

In terms of provision for impaired Assets and closing costs, in Q110 last year we had a charge of $2 million there, this year we had a charge of $4 million. Small, little things that go both ways and fluctuate. No big surprise there.

All told, operating income in the Q1 was up 23% year-over-year from $427 million to $525 million last year or an increase of 97 million. Now on these items, we are benefiting, these percentage increases we're talking up 23%, we are benefiting from where Mexico, we now have all of Mexico in the '11 number and half of it in the down below in the other number. So without that, the operating increase would still have been in the high teens.

Below the operating income line, reported interest expense was about the same in both quarters. 25.9 million in Q1 '11, up a little from 24.1 million last year. I think the difference there has less to do with interest expense but the reduction of interest expense associated with capitalized interest, which is an offset.

These amounts mainly affect the interest on our two billion debt offering which we did in February '07. By the way, 900 million of that comes due in March of 2012 and at this point, we will simply pay that off, which would be a nice interest rate as it's fixed in the low 5%.

Interest income and other was lower year-over-year by almost $13 million, coming in at 5.5 million this year versus 18.2 last year and the big variable there is other, rather than interest income. Actual interest income was up 300,000. Now last year, and it sounds like a broken record here, but last year, half our Mexico earnings were included in the income statement line item, interest income and other. In the current year, the results are fully consolidated and the joint venture partners 50% share is reported down below at net income attributable to non controlling interests. Overall, pre-tax income was up 19.5%, mid to high teens if you include where Mexico appears on the balance sheet.

On to our tax rate, our company's tax rate this quarter came in at 34.2%, about two percentage points lower than 36.1 a year earlier. Again, our tax rate benefited as well as a handful of discrete items, most notably FX earlier tax refund in one of our (inaudible) operations.

Now for a quick rundown of other topics

The balance sheet is included in today's press release so we won't talk about that. I will point out a couple of things, depreciation and amortization for the first quarter was $189 million. We have a strong balance sheet; I don't have to tell you that, plenty of financial strength. Accounts payable ratios continue to improve, in other words payables funding more than all of our inventory levels. That always is at it's peak as we approach Christmas where we've got higher sales and extraditing on seasonal items that don't get paid until the early part of next year but year-over-year we reported a year ago, accounts payables percent of inventory at 102%. A year later, 105%. If you take out non-merchandise payables, like construction payables, they're all similar type of improvement 88% a year ago and 91% at the end of the first quarter of this year.

Average inventory for warehouse was up only 1%, 11,815 million this year average inventory versus 11,676 million a year ago, so up $139,000. Again, our inventories tend to peak around the seasonal, all the seasonal stuff, in particular bigger electronic items coming in for Christmas.

Of that 139, 105 of it is the FX difference because of the strong foreign currencies relative to the U.S. dollar so inventories are darn near flat on pretty good sales this past quarter. So we're seeing the benefits of that and improved payables, and improved turns.

In terms of Capital Expenditures, in Q1 we spent $306 million. Our fiscal '11 CapEx is budgeted at just under 1.6 billion. This compares to Capital Expenditures of fiscal '10 of roughly a billion, of roughly 1.50 billion. Not a surprise, we meneioned that I think in the yearly conference call.

In terms of our dividend, our current quarterly dividend is $0.2050 per share or $0.82 per share annualized. The total cost to the company is right around $360 million.

At Costco Online, in Fiscal '010 at Costco Online comp sales were up 6%. In first quarter, they were up 9% so a little bit of an improvement there.

In terms of expansion, as you know in fiscal '010, we opened 14 locations which included one relocation, so a net of 13. This year we expect to open, we opened eight net in Q1. We've opened two so far in Q2 which is it for Q2. In Q3 we planned two openings, which includes a relocation so a net of one. In Q4 we have plans for 17, including one relocation so a net of 16. So all told for the year, our own budget assumes 29 new or 27 net new excluding the two relocations. Now as you know these are all being actively worked on in different phases of construction or getting ready to start.

The reality is, is that inevitably a few of those in Q4 may fall into Q1. My best guess is that the 27 net could easily be 23 to 25 but we're shooting for certainly 25 but we'll see where we go. So in fiscal '010 we added a net of 13, so about 2.5% square footage growth. In fiscal '011, assuming we added all 27, we'd be about 4.5% square footage growth, probably, if I were betting on this it'd probably be half a percent lower than that.

Assuming we open 27 net, it would include 15 in the U.S. three in Canada, possibly one in the U.K., just a matter of timing. Two each in Korea and Taiwan, three in Japan and one and possibly two in Australia, so again percentage wise you're certainly seeing plenty of openings in U.S. but also a higher percentage of openings overseas, notably in the three Asia countries, a total of seven planned versus typically two or three on average planned over the last few years.

As of Q1 end, some of you keep square footage figures, total square footage for our company, this by the way includes Mexico now was 82 million in 98 and that would be on the base of 572 warehouses. I'm sorry, 500 and quarter end. I'll get you that number in a second, 528. Sorry.

In terms of stock repurchases, we currently have repurchased, remaining repurchased authorization over previous board approvals of just under a billion dollars. In fiscal '010 overall as we started back up repurchasing just before Q2 end began last year, we purchased 9.9 million shares for a total of $568 million. And first quarter we repurchased an additional 2.4 million in shares for just over $150 million.

Again, our supplemental information pack which includes some useful stats and cash flow statements as well, we posted, I'm sorry, does not include the cash flow will be posted on the Costco Investor Relation site later this morning and 10-Q should be out in a few weeks.

With that, I'll open it up for questions and turn it back over to Debbie.

Question-and-Answer Session

Operator

(Operator Instructions). Your first question comes from the line of Deborah Weinswig with Citi.

Tina Wang [ph] – Citigroup

Hi. Good morning, this is actually Tina Wang, on for Deb. Thanks so much for taking my question. I was just wondering, based on what you've seen so far in November, can you just provide us on an update on your holiday outlook and also address specifically how you guys are positioned from an inventory perspective for holiday? Thank you.

Richard Galanti

Sure, well I can't talk necessarily about how the last week or so was but what I know I have mentioned and I know what Jim has mentioned when asked in the last way back, a couple of months ago, we approached the Christmas season as far back as September, somewhat aggressively, recognizing structurally we feel that a, we've had great shopper frequency. We have on average a little bit more upscale member that perhaps can weather the economic storm on average a little better. But hopefully it will pick up some of those discretionary items as well and structurally we can afford to be a little more aggressive because of the types of merchandise we sell and the terms that we have. We're in and out of seasons early so we have continued to approach with a plus sign in front of it, if you will versus a caution and that continues.

Tina Wang - Citigroup

And is there anything from Black Friday that you observed, that you could call out?

Richard Galanti

Not really. For us, Black Friday, while we do, in the last several years we've done a handout with a few items in it. It's really more of an advertising traditional retail holiday. Certainly, Black Friday is better for us than an average Friday but it doesn't really pretend anything out of the ordinary for us. And it was reflected in our November comps by the way.

Tina Wang - Citigroup

Great. Okay. Thank you.

Operator

Your next question comes from the line of Charles Grom with JPMorgan.

Charles Grom - JPMorgan

Thanks. Good morning, Richard. I know you don't want to give forward guidance but just provide the Mexico consolidation. Would you anticipate that minority interest line to be up $20 million per quarter this year or was there something in this quarter that made it pretty high? Just trying to get a sense of how we should model that line?

Richard Galanti

Well I can't give you guidance on it other than you note in that line there is that tax benefit I mentioned. There won't be that high, I think that low under five million of that line is a tax benefit because of Mexico.

Charles Grom - JPMorgan

Okay, so closer to that 15 maybe?

Richard Galanti

I'll let you do that.

Charles Grom - JPMorgan

Okay, fair enough and then in your 10-K you filed last month, you reported, I think about 100 basis point increase in Canada. What was behind that increase and do you feel like that 4.5% is sustainable?

Richard Galanti

You're talking about year-over-year?

Charles Grom - JPMorgan

Yes, year-over-year.

Richard Galanti

Well, I think first and foremost Canada's economy overall, not just at Costco has been strong. We've enjoyed local currency comps for two years now in the mid to high single-digits in Canada. My guess is that as a smaller benefit of that is related to the fact that Sam's exiting the market gosh a year or a half ago where they had six to eight locations in the Toronto, Montreal markets. Certainly, that helps a little bit but as you might expect the day that was announced, Jim was the first to remind the buyers he doesn't want to see big improvement in margins there. So my guess is that's a little of it but a bigger thing is continuing strong comps up there.

Charles Grom - JPMorgan

Okay, fair enough and then my last question is within SG&A you talked about the core being 17 basis points better, 16 from payroll. Is that just leverage or is there something else that helped out this quarter because that was particularly strong?

Richard Galanti

Well part of it, I think it's both. As I mentioned a minute ago, clearly some of it's leveraged but I think also our, and again I don't know what the leverage comp number is completely but I just believe and we all agree that it is lower than it used to be. We have focused on it over the last year and a half. Everybody has focused on it but as so many of you know for years I've always said there aren't a lot of silver bullets in our SG&A because we're pretty sufficient to start with.

Well guess what, in the last two year's, everybody's been focused on it a little more and little things are being taken out of operations and payroll. And yeah and so keep in mind as Bob was just mentioning to me, benefits are higher in that number, higher than sales growth so actually, overall there was a little more improvement that offset that. So, you know again, there's lot of little things plus pretty good comps.

Charles Grom - JPMorgan

Great. All right. Thanks.

Operator

Your next question comes from the line of Adrianne Shapira with Goldman Sachs.

Adrianne Shapira - Goldman Sachs & Co.

Thank you. Richard, another impressive point of the quarter was the core merchandising margins up 19 basis points. Could you just kind of walk us through and help us think about how sustainable that is? Clearly a nice inflection part but as we head into the second quarter we're up against a pretty tough compare where you had a nice increase a year ago as well, so just kind of help us think about how sustainable that improvement is going forward?

Richard Galanti

Keep in mind the big improvement last year in Q2 really related to the year before that when we took about 30 to $35 million of commodity price markdowns so the Delta a year ago was because of the rollout performance a year earlier. So I don't see that as being a concern this year. Look, one of the things I pointed out a minute ago was even our overall Fresh Foods gross margin was up in Q1 not withstanding a much weaker, for us, bakery margin we were trying to hold prices, despite the raw material prices going up.

You can't do that forever but we recognized that these, a lot of those muffins are sold to restaurants and delis and the longer we can hold that price the better. It won't be forever but we're able to do that and still have pretty strong margins here. As Jim has said before and years ago I not sure I always agreed, but I agree more and more, margins aren’t' the issue. We feel pretty good that we have the ability to do a little of that but we're not going to go crazy.

Adrianne Shapira - Goldman Sachs & Co.

Okay and so we're seeing this margin improvement despite the fact that we're not necessarily flowing through some of the inflationary pressures that have yet to, that have started to materialize? Is that fair?

Richard Galanti

Yes, again where the inflationary pressures have started first would be Fresh Foods, Bakery, sugar, the raw materials we use for baked goods or the food court. And again both of those margins in first quarter were down year-over-year because we're holding on but we're able to do, by the way, we'd probably have done that even if there was margin pressure in the whole company. The good news is we're able to do that even within Fresh Foods margins so I think, overall I think, we're running on all cylinders as it relates to our merchandising, most cylinders as you would say, not all but in terms of merchandising and our ability to achieve our margins.

Adrianne Shapira - Goldman Sachs & Co.

What do you think competitors do as it relates to inflation? How aggressive it is out there and maybe sort of on the heels of Black Friday how the holiday season started off compared to? How would you characterize the holiday season relative to what your expectations?

Richard Galanti

Well, I mean, again I get back to the comment I made a minute ago on the latter part of the question is that we've, we entered the season positively and we still feel that way. The first part of your question, Adrianne?

Adrianne Shapira - Goldman Sachs & Co.

I'm just saying as it relates to inflation, what you're seeing competitors do with prices given some of the inflationary pressures?

Richard Galanti

It's seems to be all over the board. If you think about Fresh foods, I think the supermarkets have their own set of pressures. Again, we're stronger in bigger ticket higher end beef items like prime rib and steaks and what have you and that's where there's a little less pricing pressure. We're still the best value out there but the ad items you see for ground beef and things like that aren't as big a competitive issue for us.

We're able to compete effectively and not be impacted a lot. Different regions are doing different things on that side with launch leaders. I mean you get driven crazy in a region or two whether it's milk or soda pop or things like that but as it relates to pricing pressures, I think we would all agree here that we're going to be the last to take prices up

and so far, that's happened and that's good for us. And we're able to do that and still show decent margins.

On the non-food side, there's, you hear about cotton going up a lot. Well it does, it impacts those items but it impacts little higher ticket items less than $8 items at the discount stores.

Adrianne Shapira - Goldman Sachs & Co.

Makes sense. So Richard, let me be the one to ask the question. Since we last spoke, the Board in California raised the threshold, BJ's talk about raising their membership fee in January. Sales seem to be improving. Understand that you're focused on the holiday season but maybe just update on your thoughts as we think about 2011 as it will be five years since we last saw a membership fee hike? Thanks.

Richard Galanti

Well, there's not a whole lot of new news yet other than what you just mentioned. As you know, we raised it from the base numbers from 45 to 50 I think it was May, roughly, May of '06 so five years would be May of '011 but we really haven't talked about it yet. I don't think what our competitors do impacts us a lot. Certainly our renewal rates, our frequency and the like give us confidence that if and we wanted to, it would not be an issue as it never has been but we honestly haven't sat down and talked about it yet.

And at some point I'm sure it will happen but whether it's sometime in the first half of '11 or the second half of '11 or the early part of '12 who knows. I'm not trying to be coy here but we just really haven't talked about it yet but it is not because of a lack of confidence in our loyalty in our ability.

Adrianne Shapira - Goldman Sachs & Co.

Okay. Best of luck.

Operator

Your next question comes from the line of Mark Wiltamuth with Morgan Stanley.

Mark Wiltamuth - Morgan Stanley

Hi, good morning. Richard, we've seen a bigger push towards the Asian stores in this years new store introductions. Is this something we could count on for the next several years and do you have a longer term target that you're shooting for there in terms of store count?

Richard Galanti

If you go back a few years ago when we had the slide that said this is how many we have by country today, this is what we think the potential was 10 years from now, I thin in both Korea and Taiwan, we had at the time four or five in each of those countries. We felt long-term it could be 15. While I haven't seen that slide lately, I think in the past year I saw it and the 15's were 25's. In Japan, when we had three or four units the potential for some reason was 49. I don't know why it wasn't 50. I don't think that's really changed other than we have committed to a lot more. We have what nine, I believe in Japan and seven in Korea and six in Taiwan.

As I mentioned between those three countries we've got several opening this fiscal year and yes you'll see a higher rate of openings this year and the next few years than you have in the past. So it moves the needle for the company a little bit. We've had great success in those countries. We've had great success in the one unit we have in Australia. We're anxious to get our second open this coming Spring and hopefully a third, my guess is that third slips into Q1 of '12 but we're working to try and get it open. So, we'll see but I think it's like a lot of things around here, it's a big positive for those operations given that they are successful. It's a slight positive for the company overall that are trending in that direction.

Mark Wiltamuth - Morgan Stanley

How do the operating margins look on those stores versus like a U.S. core store?

Richard Galanti

Margins higher. Keep in mind in places like Korea and Taiwan, I think eight of our 10 highest volume units are in the three Asia countries. And I wouldn't be surprised if all 10 were, if they were a little older. So, I mean it helps when you have four or five locations and a 15 plus million-population city like Seoul or Taipei or Tokyo. So we have met with good success and member signups and sales over there and we expect to keep opening some units. (inaudible) is higher, payroll is, because sales per location are quite high, payroll as a percent of sales is lower but the net of everything, membership fees tend to be higher. Some of those units have twice the average number of members as our company overall. But again that has to do with the fact that there's so many, so densely populated and they like American stuff. What we feel that we've brought is not only the unique membership format but American sourced goods, bigger and great value.

Mark Wiltamuth - Morgan Stanley

And getting back to the inflation question, you said steak prices up 15%, what kind of price elasticity response do you get there? Do you see volumes down a little bit in some of those areas where you're seeing double-digit increases?

Richard Galanti

I honestly don't know. My guess is, there's got to be some elasticity. It probably was, there was huge elasticity that was positive. When the economy first got hit in '08, throughout the first half of '09 as we all called it, the high-end steak restaurants which were hammed, 2% of all beef raised in the United States is prime. Virtually all of it went to high-end restaurants.

There were weeks and months in the middle of '09 where we represented something like 35% of all the prime steaks being sold in America, including restaurants so as they slow down and the price points in these items and again, this is anecdotal but I do remember a prime steak that we might have was selling at 18 or $19 a pound for a strip steak but we didn't sell them because the disparity was so different was down to 10.99 and 11.99 and we could sell a dramatic amount of them even as the 10 and 11.99 choice steak went to 8.99. I'm guessing on these numbers but directionally that was the issue. So, my guess is there's some elasticity but it's good news for us.

Mark Wiltamuth - Morgan Stanley

Did you say your Fresh Food margin was down a little bit because of inflation?

Richard Galanti

Our overall Fresh Food margin, which is the sum of bakery, produce, meat and what we call deli, packaged items like cheeses, what have you, our overall gross margin was up in the quarter. Notwithstanding the fact that our produce and our bakery margin was down because of holding prices on many of those items. We can't hold them forever but so far we have.

Mark Wiltamuth - Morgan Stanley

Okay and how about on the meats? Were you holding there or are you passing it through?

Richard Galanti

Mostly able to pass most of it through. Again on ground beef we might not be able to but we're selling a lot of ground beef, we're selling a lot of steaks and roasts and things like that, higher end cuts, where it's kind of like in the Whiteford's business, with refrigerators, the one you see on sale is the base model but when you go in to buy one you want to buy the model with everything on it, like with the icemaker and the water dispenser and so that's not the one that's on sales so there's less price competition on the high end products?

Mark Wiltamuth - Morgan Stanley

And just a little more color on California doing better, is it back to reasonable levels or it still just benefiting from the (inaudible)?

Richard Galanti

I would say, well in November it was. Over the quarter, closing in on it, so yes, it's getting better. I don't want to suggest that life's great our there. We all know what the underlying unemployment statistics and the economy concerns are but certainly seems, I think probably the thing that has continued to surprise me, is the improvement of shopper frequency. For 20 years shopper frequency, year-over-year each month was on average up 1%, 1.5%.

All of a sudden, starting really before the economy got bad in late '08, in the Spring of '08 when gas prices approached $4, we started seeing frequency improve. And throughout '09 when the economy was really in the doldrums we continued and I was the first to remind people that hey if we're running, if we typically run one's and two's and we're running three's and four's a year from now if we're flat that's not so bad because we had all that frequency in one year. Well guess what, we're running three's and four's and five's for two years running now.

It has to do with the fact that to some extent people change some of their habits with restaurant usage in '09. I think competitively we are still taking market share from traditional supermarkets and that's what drives frequency in our business and that helps.

Mark Wiltamuth - Morgan Stanley

I would think with the three's and four's and deflation shifting back to inflation you should start to see more sustainable comp above four. Is that fair?

Richard Galanti

Hopefully. Yes, if that happens. We'll hope that it'll continue.

Mark Wiltamuth - Morgan Stanley

Okay. Thank you very much.

Operator

Your next question comes from the line of Mark Miller with William Blair.

Mark Miller - William Blair & Company

Hi. Good morning. Richard, on the average ticket, November strengthened ex-currency, ex-gas and a lot of our discussion, I think has been around price changes on like items? Could we spend just a minute on mix and what I'm specifically interested in is are we beginning to see a shift from what had been trading down for the last couple of years to more trading up so within categories and also on moving towards better, best items, I know with the (inaudible) signature that actually depresses that changes but X that factor what are the buyers seeing there?

Richard Galanti

Well, first of all I think we did a good job per Jim's instructions, the buyers, that when they come they originally got hammered. We tried very hard not to bring price points down. Now did we try some lower price points on patio furniture to get below $1,000 or a little above a $1,000 at a price point, yes. Did we sell a little better? Yes. Did we do that again this year leading into February through April of '10, second bad February through April of economy? No. And we're actually scrambling, because I think part of it was (inaudible). So, now are we getting, I think the ticket has come down a little bit because people are coming in more. It's caught up a little bit because there is finally a little more strength and penetration of what I'll call medium to higher priced non food items, discretionary items.

Our jewelry business has been up in the teens the past couple of quarters, the past several months. A lot of those categories, I mentioned earlier, housewares and sporting's goods and modern garden are all up in the 10 to 25% range. Actually on a high water mark basis over two years, net positive. So again, frequency brings it down a little bit. We're finally seeing some strength bring it up a little bit but we still are, as Jim would say, operate in a healthy state of paranoia because the economy's a little scary but clearly we're getting more than our share.

Mark Miller - William Blair & Company

And is it fair to make a connection between that second derivative or rate of change of average ticket and payroll leverage, where the strength would presumably help you get better payroll leverage, all else being equal?

Richard Galanti

Yes, that helps.

Mark Miller - William Blair & Company

Okay. My other question is on international club expansion. Can you just help us look out a few years? I mean the returns are absolutely terrific and is there is a speed limit we should think about with the infrastructure? I mean can you get the International club openings up? When can that surpass the U.S. for example? Could you get it up to 20 per year?

Richard Galanti

I think it will be a few years. The way I looked at it we're probably a four or five year period. If I think of it just like the three countries in Asia were we are now, then we currently have 23 warehouses between the two countries. All right and probably for five years running we've averaged between the three countries a total of three a year. This year we'll open five or six, and my guess is over the next five years it could be five or six a year. I hope maybe six, or seven or eight but let's say five or six years.

That's a dramatic increase in rate of increase and it still does not get you to your 20. As we open the second or third European country over the next five years, but again as you've seen from every other new country we've operated in, in over five years we may open three to five units in total in any given country. So, we're still pretty hands on, infrastructure wise as it relates to getting them opened, again I think the first signal is we have ramped up but not to 20 a year but we're ramped up. Let's see how the next two or three years go.

Mark Miller - William Blair & Company

Thanks.

Operator

Your next question comes from the line of Bob Drbul from Barclays Capital.

Bob Drbul - Barclays Capital

Hi. Good morning. Richard, I guess the question I have is on the membership fee, you know the potential for a membership fee increase, how should we think about I say attrition if you were to increase hypothetically the Executive Membership by five or 10%, or $5 or $10 given historical attrition on just the Gold Star increases you guys have done over the years?

Richard Galanti

Well a; who knows but in the five increases in 25 years we've never, I think we've budgeted as much as 1.5 or 2% of attrition and I don't think we've ever exceeded one even so it's really never been an issue. As you know, nine years ago and five and a half years ago or five years ago we did, when the original executives started at 100, we were at 40. And then we went to 45 and we've kept the 100 and then went to 50 and kept the 100 to 100.

The theory being is to get more people to convert and that's happened. I don't know if and when we look at increasing the base fee, what we do with the other fee. It really, I'm not trying to be coy or cute but we'll let you know when we figure it out some point. But as it relates to your question of attrition, we don't lose a lot of sleep about that quite frankly.

Bob Drbul - Barclays Capital

Okay and I'm just curious on another, inventory availability from some of your vendors. I guess the one's that get a lot of mention these days is the television category. I was wondering if you might be able to talk a little bit about television category and then we'd also be interested in hearing a little more on the Softlines inventory availability?

Richard Galanti

Well, there's a few different things. First of all TV's are fine. Cameras have been a little, certain high-end camera's I've heard have been, this issue of availability issues because of chips, or whatever components of these $1,000 or plus digital SOR cameras. The TV's, the availability is back but recognizing TV sales overall have been down a little bit for us as they have for everybody. In terms of apparel, the second thing first of all is the issue with importing from Asia. There has been some challenges with shipping, that affects all of us, not just Costco. So far we have done pretty well through that. In some cases there's been a week or two of additional lead time which the buyers have been able to build, by the way it has not affected our inventory results, our feel of control over inventory so that's not been a big issue.

Probably the single biggest thing right now that's a little bit of a pain is some of the electronic toys, the Xbox Connect. We like everybody are being allocated some of the Nintendo items so we're all, it's a high quality problem to have but we're could all sell more if we had it.

Bob Drbul - Barclays Capital

Okay and then just one last question from me, Richard is just give us an update on any of the healthcare cost trends that you're seeing in the business currently?

Richard Galanti

Not so big right now. Again as I mentioned in Q1 the rate of increase was a shade higher than top line sales growth. It was closer to 10 and 12, than it was 15 or 17, in terms of dollar increases. So that's encouraging a little bit. We're tweaking a few things that we're allowed to tweak without impacting, losing the grandfathering of all the new requirements over the next several years. Again, I think we're finally breathing a little sigh of relief after two years of really big growth and healthcare cost exacerbated.

Opening few units, having less turnover and with fewer units having less part time is up to full time hourly without having all those new items you have less freebies in those calculations and as we ramp up expansion that just helps.

Bob Drbul - Barclays Capital

Thank you very much.

Operator

Your next question comes from the line of Rob Simone from Cowen and Company.

Rob Simone [ph] - Cowen and Company

Hey guys, It’s Rob Simone in for Laura. I just wanted to touch on the membership fee increase again or one more time. I believe if I recall you guys called out a weaker economy rate in the near time. I know you just said you’re not going to be increasing the rate and you haven’t announced it yet but can you comment at all on how your view of the macro backdrop changes? Thanks a lot.

Richard Galanti

I think the comment I made was anecdotally I remember sometime in mid '09 to improve our earnings we wouldn't do it for that reason. Historically, we're going to do it when we're ready to do it and we feel comfortable and certainly the backdrop of the economy tempers that enthusiasm, not from the standpoint of the ability to accomplish it and accomplish it with very little attrition and disloyalty but the ability to why be arrogant about it or invested about it. Let's wait and see so again as you know around here, because we, whatever the issue is, whether it's this or any issue out there that we're thinking of doing it doesn't take us a long time once we decide to do something to do it.

We haven't talked about it yet other than anecdotally and like what I just said so I'm trying to beat around the question here. The answer to the question because at this point we haven't decided what we're doing and when we find out we'll let you know.

Rob Simone [ph] - Cowen and Company

Okay, great. Thanks guys. Good luck.

Operator

Your next question comes from the line of Greg Melick with ISI Group.

Mike Montani- ISI

Hey guys, this is Mike Montani in for Greg. My question was actually on ticket first which was just looking back historically to mid '09 we saw a 3% to 4% decline in ticket if you excluded FX and gas and obviously now we've gone slightly positive so number one just trying to understand if you can help us with the driver there? It seems like inflation is an obvious one. We're getting a little bit of mix but is there also some improvement in units per basket as well that you could speak to?

Richard Galanti

I think, I don't have the numbers right in front of me. The units for baskets hasn't really changed dramatically other than as frequency goes up part of it is. I used to always say that the typical family member at Costco was coming in every two and a half, three weeks but each of those families were still going to the neighborhood supermarket three times a week. Well I think what's happened is that three became two and a half at our Costco in terms of more frequently. They're still going to the supermarket but they're buying more food items at Costco. They're coming in more often and buying a few less items or maybe a few or equal number of items but some of those food items so a little lower basket. So again, it's the recent relative pickup in the average basket is I think less inflation because it's really just starting and more the strength in some of the non food categories offset by more frequency.

Mike Montani - ISI

Okay and then following up on that with, getting aback to TV's for a moment. Obviously last quarter I believe the outlook was for slightly positive TV dollars and we haven't quite seen that as of yet but I guess looking ahead it would seem that's one leg certainly to get the ticket a bit higher. As you see the units improving a bit with accelerated ASP declines, is there any reason to think that we still wouldn't be able to do positive dollars into 4Q?

Richard Galanti

Rob was just mentioning something. I was ruffling through my papers to find the answer. In November units were actually up a little bit. There was a little bit more than that amount in inflationary pricing which is by the way up a little bit for most of '10, the most of first half of '10, inflationary pricing included. So I think everybody's got a lot of TV's and we're seeing some strength as the price points keep coming down a little bit. That helps. It drives it a little bit but not a lot but I'm really shooting from the hip with this answer, guys. I don't have any detail in front of me other than what we're talking about in general. One of the things that has driven our TV is the coupon mailers that we do. What we call the (inaudible) mailers. Throughout a lot of this current calendar year there's been fewer of that as those inflation, there was a lot of pressure on vendors to have to provide some of that setup. We're starting to see a little bit more of that, not as good as it used to be but we expect that to improve so that factor bodes well for electronic sales in Calendar 11. But I don't know how that's offset by how many TV's everybody already has. 3D is not exactly changing the face of TV sales overnight so that's a much slower process.

Mike Montani- ISI

Okay and just lastly, actually had a question, somewhat of a macro question but if you look at the accelerated depreciation provided for in the new tax package? So basically 100% of expensing of business purchase of CapEx, is there a way to think about that as it relates to your business given obviously the member, the business member penetration that you have, especially I would think around office products, furniture, PC's, et cetera? Have you thought about that or done any work to quantify it at all?

Richard Galanti

I have not and I'm not sure if our buyers have either yet. It's pretty new. We had it, it can't hurt and hopefully it'll help but I'd be remiss if I tried to guess what that would be. Keep in mind, each of these departments are small percentage departments of the total company. So it helps us, it doesn't, if furniture, and cash registers, PC's and things like that, would benefit from this, it will help those departments a little bit. Office products as an example, (inaudible) for an example is about 6% of sales so probably half of that is business related, half is not. So if it impacts that a little bit that's great but it's still a small piece of the action.

Mike Montani- ISI

Great, well thank you guys. Good luck.

Richard Galanti

Why don't we take two more questions.

Operator

We actually have one more question from the line of Neil Currie with UBS.

Neil Currie - UBS

Thanks for taking the question. Congratulations on a great quarter. Just wanted to ask about Internet sales. Most of my questions have already been answered. When you look across some of the larger retail businesses and you look at the Internet sales, stay significantly ahead of the store sales. I mean your Internet sales aren't bad. They were 6% last year, 9% this year but not significantly outpacing what you're seeing in your stores. I was just wondering what your approach and if you might see any changes to your online sales whether you're not too worried about developing online or whether you think this is a good performance?

Richard Galanti

Well, I think we can do better. Keep in mind, the average ticket on line is still in the high 300's for us. So and it's all discretionary, virtually all discretionary stuff. And that's by choice. We are doing a few things right now. If Jim was sitting here he would say well first and foremost we have to have the right items at the right price. And so it's all about merchandising but I think we can do a better job in several other things. I'm not promising anything other than we agree that even though nine is better than six, and six was better than a slight negative the year before, arguably a lot of that's is because of the nature of the discretionary items we sold. We think there's opportunity there and we're working on that and we really are working on that but it's not going to happen over night.

Neil Currie - UBS

Okay and just on, you talked about Asia but I was just going to ask about the U.K.? In terms of those numbers you gave a few years ago in terms of potential store openings, are you still on track for those or is there anything in the U.K. economy that you see to revise your outlook and perhaps allocate the capital elsewhere?

Richard Galanti

Well, fortunately capital is not a big allocation issue for us. I think in the U.K., the fact that the economy has been in the doldrums for a couple of years and there was one other unique thing that the U.K. has in our operation. To make it work for us from the beginning of time, many allocations are located and I don't know the exact formal term over there but they are not retail zoned.

Neil Currie - UBS

PPT6 I think it is.

Richard Galanti

And so, because of that there's a limit to how much of our sales can go to the Gold Star member. It has to go to the trade and those numbers are typically in the roughly two-thirds of the sales range. A little bit higher than our company average so we don't market a lot to Gold Star members. So structurally it's been a little different business all along but a good business. I think the fact that the economy has got hit hard the last couple of years over there has, I don't think we have canceled anything.

There's also a lot of limitations and process to through. I think I used to say that we might be working four or five sites hoping that we get approved for one of them that will finally get opened three or four years from now. And so there's a harder real estate environment for us over there and the fact the economy has bee so, my guess is that five years ago if you had hey five years since which is now 21 or 22 locations there what we open in the next five years, my guess is that number is down a little bit from what we would have guessed five years earlier but we're still looking at openings and have plans to open new sites over there. I mean we've got three or four that Jim and Jeff have approved and we're working on it.

Neil Currie - UBS

How would you convert the real estate environment there compared to Japan as difficulty getting sites and opening them?

Richard Galanti

I'm guessing a little bit here, Neil but I would think that the process, Japan's more expensive but the process of getting them is easier.

Neil Currie - UBS

Great. Thank you.

Operator

At this time there are no further questions.

Richard Galanti

Thank you very much, everyone. Thank you, Debbie.

Operator

You're welcome. This concludes today's conference call. You may now disconnect.