Costco Wholesale Corporation (NASDAQ:COST) Q3 2010 Earnings Call May 27, 2010 11:00 AM ET

Executives

Richard Galanti – CFO

Analysts

Robbie Ohmes – Bank of America

Mark Miller - William Blair

Charles Grom - JPMorgan

Mark Wiltamuth - Morgan Stanley

Adrianne Shapira - Goldman Sachs

Peter Benedict – Robert W. Baird

Robert Drbul - Barclays Capital

Laura Champine – Cowen & Company

Deborah Weinswig - Citigroup

Colin McGranahan – Sanford C. Bernstein

Neil Currie – UBS

Dan Binder – Jefferies & Co.

Damian Witkowski – Gabelli & Co.

Operator

Welcome everyone to the third quarter earnings release conference call. (Operator Instructions) Mr. Richard Galanti, you may begin your conference.

Richard Galanti

Good morning to everyone. This morning's press release reviews our third quarter fiscal 2010 operating results for the 12 weeks ended May 9th.

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 our 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 third quarter fiscal 2010 operating results for the quarter, earnings per share came in at $0.68, up 42% from last year's reported third quarter earnings per share of $0.48. As will be discussed in more detail in a moment, both this year's and last year's Q3 results and the comparison of these results included a couple of items of note.

These were outlined in this morning's press release and include the following. First you will recall that last year in Q3 we took a pre-tax charge of $34 million related to a litigation settlement covering our membership renewal policy.

This charge hit the membership fee income line of our income statement last year in Q3 for $27 million and our SG&A line item for $7 million, negatively impacting last year's third quarter earnings by $0.05 a share.

This year in Q3 our SG&A line was reduced or benefited by a $14 million pre-tax reversal of part of a charge related to a Canadian tax liability that we had previously taken in the second quarter of fiscal 2007. This had to do with stock option protection, the option issues and protecting our employees in Canada who received such options.

This is an SG&A impact not an income tax impact. So adding back the $0.05 to last year's third quarter EPS of $0.48 and subtracting the $0.02 EPS pick up I just described, year over year Q3 EPS would have gone from $0.53 last year to $0.66 this year for a 25% year over year increase.

As I'll discuss there are other items of note that impacted each of last year's and this year's fiscal third quarter results, some positive items, some negative, from income tax rates to LIFO to FX, closing costs, etc.

I will mention the FX issue right now, what I refer to as FX tailwinds, as you know the US dollar this year as compared to last year relative to several of the foreign countries and countries in which we operate, had weakened so our foreign earnings results when converted and reported in US dollars has helped us this and has helped us in Q3 by a little over $28 million pre-tax or $0.04 a share.

That is assuming FX exchange rates were flat year over year, this year's foreign operating results in Q3 would have been lower by that amount. In all we look at our Q3 results as a continuation of positive trends that we saw in Q2.

In terms of the sales for the 12-week quarter reported total sales were up 12% and our 12 week reported comparable sales figure was up 10%. For the quarter both total sales and comp sales were partially impacted by gasoline price inflation and by the strengthening foreign currencies relative to the US dollar year over year.

On a comp sales basis the plus 6% US sales increase in Q3 that's outlined in the press release, if you exclude gas inflation that would have been a plus 3%. Similarly the reported plus 26% international comp figure assuming flat year over year FX rates would have instead been plus 8%. And total company comps, again we reported a plus 10% for the quarter.

Excluding both the gas inflation and excluding FX changes would have been plus 4% for the company during the fiscal quarter. Other topics of interest, our operating activities and plans, we opened one new location in Q3 in Pacoima, California, that's within the city limits of Los Angeles.

In Q4 which began on May 10 we plan to open six new locations. The first of these six opened this morning in St. Johns, New Brunswick, Canada. This is our 78th Canada warehouse location and brings our total warehouses worldwide to 568.

The five additional buildings we plan to open by fiscal year end include two additional ones in Canada, one in Queens, New York, in an area called Rego Park, one in Roseburg, Oregon, and our 22nd location in the UK in Coventry, which is about 95 miles northwest of London.

Also this morning I'll review with you our expansion plans for fiscal 2011 which are up, Costco online results, membership trends, certainly a discussion a little bit more about margins and SG&A, an update on our stock buyback activities, and a couple of other items of interest.

In terms of a discussion on the quarter's results, again sales for the quarter were $17.4 billion, up 12% from last year's Q3 of $15.5, again on a reported comp basis it was a plus 10. The plus 10 third quarter comp was comprised of a 9 in February, a 10 in March and an 11 in April.

There were some seasonal, some holiday changes, but essentially pretty close range there. And again excluding gas and FX, the 9, 10, and 11, for February, March, and April, would have been a 4, 3, and 4.

The 10% reported comp was positively impacted by about just under 4% due to the year over year strengthening of foreign currencies relative to the dollar and as I mentioned the local currency comp rate if you will for all the foreign countries was a plus 8 but when converted into US dollars because of the FX was plus 26.

As I mentioned gasoline had a big impact, about three percentage points such that the reported US comp of 6 would have been a 3 without that. Our average transactions increase was a little over 6% for the quarter which of course includes gas inflation and FX. And the average frequency increase was a little more than 3.5%.

In fact the frequency trend during the past three calendar reporting months of February, March, and April, was a 3.7, a 3.5, and 3.7 so pretty consistent. I think most importantly that these frequency figures are on top of a roughly 4-plus percent frequency increase during Q3 of 2009 so pretty strong frequency continuing, recognizing people seem to be coming in more frequently but are buying a little less each time, perhaps buying a little more on the food side as well.

For the quarter in terms of sales comparisons by geographic region, for the quarter the Midwest, southeast and Texas were the strongest, followed by a good showing in the northwest. California actually trend wise over the last four quarters have also had a good, an improving track record but at a lower level.

Internationally in local currencies, we’re doing quite well despite all the craziness around the world. Canada in local currency is up close to 10%, with Taiwan, Korea, averaging in the mid teens. UK is closer to flat. In terms of merchandise categories for the quarter, soft lines was the strongest core category followed by fresh foods, food and sundries, with hard lines being the relative weakest of those four.

Within food and sundries, every sub category was positive in the quarter ranging from 1% up to 12% up. Tobacco was actually a little bit higher than the 12 but that was an anomaly related to I believe an increase last year that tends to greatly vary sales levels based on a pending tobacco tax increase.

Within hard line, the comp, the strongest sub categories were sporting goods, hardware, health and beauty aides, lawn and garden, and tires. The one of note that was a slight negative comp was what we call majors or electronics. That’s not inconsistent with what I think Bob Nelson has said on the monthly sales voice calls.

What we’re seeing in TVs is is there’s not a lot of promotional activity out there as the underlying components of the flat screens, more notably the panels, as demand has increased in Asia from Chinese consumers and what have you, that there's less need for the manufacturers to provide incentives and as you've seen in our mailers over the last several months, there's not as much exciting activity in terms of promotional activity for TVs.

Within the soft lines comp, most every category was strong. Generally every sub category but one was in the 9 to 22% comp range, with housewares, small electrics, domestics, media, home furnishing, being stand outs. And with fresh foods, all sub fresh food categories, meat, bakery, produce and what have you, were all positive, each in the mid to high single-digits and averaging in the high single-digits.

Now moving down the line items of the income statement, I'll start with membership fees, and again recall membership fees, first I want to take out the component of that $34 million charge from last year, $27 million of which hit last year's Q3 membership fee income line. So I'm going to take that out in terms of comparison and then of course I'll show you without FX since with the relatively weaker US dollar we show dollar increases greater in the foreign countries.

On a reported basis for the quarter this year we had $395 million or 2.27%. Reported last year was 329 but again I want to add in the $27 million such so that the comparison to $395 will be 356 or 2.30% and that's again without that membership litigation settlement in Q3 of last year.

So on that basis 395 versus 356, dollars were up 11%, and basis points were down three basis points and in dollars it was up $39 million. Now again, another complication is gas inflation which tends to screw up some of the percentage comparisons. That minus three basis point number without gas inflation would have been plus four basis points.

So pretty good showing given the sales strength and relative membership strength. Now let's talk about FX, again FX last year the 356 number would be starting point, the 395 assuming flat FX year over year would have been 381, which I think is probably the most appropriate comparison.

That would show that dollars were up $25 million excluding FX or currency are up 7%, the same reported minus three basis points but again excluding gas inflation would have been plus four basis points. A lot there to digest but I think that's the best way to look at it.

In terms of membership we've got strong renewal rates. We continue to see improving and increasing penetration of the executive membership and really despite only two net new openings in the past six months in Q2 and Q3 combined, new membership sign ups in Q3 were up 2% year over year in the fiscal quarter. That's actual new sign ups.

In terms of the number of members at Q3 end, we had [gold stars] at 22.2 million, that compares to 22.0 million at the end of Q2. Business primary 5.75 million versus 5.7 million at the end of Q2 so slightly up there. Business add on rounding down to 3.3 from a 3.4 a quarter ago, part of that is is that as add ons become executive members if they're individuals they go into the gold star category so really I think the 22 to the 22.2 in gold star probably is a little lower then that 200,000 person increase which part of that is an offset to the reduction in add on.

All told, you add up the numbers is 31.1 million households at the end of Q2 and up to 31.3 million households at the end of Q3. And if you include spouse cards we went at the end of Q2 56.9 up to 57.4. Now these numbers by the way do not include Mexico since we don't consolidate including Mexico the 57.4 would be 60.3.

At Q3 end on May 9 our paid executive member base was just a shade over 9.9 million an increase of 292,000 or 3% in just the 12 week second quarter. So we added about 24,000 executive members per week during the 12 week third quarter. Executive members now represent about a third of our membership base and just about two thirds of our sales.

In terms of membership renewal rates, they actually tweaked up a little bit in the quarter. We went from a 92.0 on the business side renewal rate at Q2 end to a 92.1 and on the gold star side from an 86.0 at the end of Q2 to an 86.3 at the end of Q3. All told an 87.4 is now an 87.5.

Those are figures by the way which they've always been for US and Canada since some of the newer countries have a lot of new locations which tend to distort that so we've always done it that way. Now going down to the gross margin line, our gross margin in the third quarter was lower year over year by 11 basis points from a 10.99 down to a 10.88 this year. The two things I asked you to jot down of course are the two matrixes for the gross margin and SG&A we'll start here with the gross margin, the line items are merchandising core, ancillary businesses, 2% reward, and LIFO and then of course total.

And we'll look at Q1, 2 and 3, for this fiscal year, going across merchandising core plus 15 basis points in Q1, plus 15 in Q2, minus 10 in Q3. Ancillary minus 20, plus 16, and plus 6. Two percent reward minus 3, minus 1, minus 3. LIFO minus 1, minus 4, minus 4. For a total in Q1 year over year was minus 9 basis points, in Q2 plus 26, and in Q3 minus 11.

Now again the craziness here in terms of understanding percentages has to do with gas inflation or last year we were explaining gas deflation, and keep in mind if you have gas inflation this year you're denominator in calculating any number over the reported sales number is going to tend to lower the percentages. So on the margin side lower means it looks a little worse, on the SG&A side lower means it looks a little better and I'll try to explain that to you here.

So if you start with the overall number of 11 basis points, within this 11 basis point figure our core merchandising gross margin as I showed in the matrix was down 10 basis points and ancillary gross margins principally gas contributed 6 basis points. On a standalone basis our gas gross margin was actually up close to 50 basis points.

But because it's a gross margin business that's 700 or 800 basis points lower gross margin than the rest of the company in the low to mid single-digits that increased penetration at that lower amount notwithstanding a pretty good year over year gross margin improvement in the gas business contributed 6 basis points there.

Sales penetration of our higher margin core businesses was down two percentage points in Q3 representing 81% of our sales this year versus 83% of our sales last year. So whereas our sales penetration of our ancillary business again gasoline sales which is a much lower margin business was up two percentage points the rest of the business was down two percentage points.

The sales penetration of our core merchandise business was down year over year as you see here the minus 10 basis point number. If you look at just the core merchandise business margin versus the core merchandise business sales, and again that's food and sundries, hard lines, soft lines, and fresh foods which represents right around 80% of our total company those realized gross margins in those realized businesses in Q3 were up 14 basis points year over year.

But again the lower sales penetration caused it to be down on this chart. With respect to merchandise category gross margins were the strongest in hard lines, followed by soft lines and then food and sundries. Fresh foods margins were actually down year over year primarily to lower gross margins in meat.

In talking to Jeff Lyons who's senior VP in charge of fresh foods, meat has tended to be inflationary during the quarter but still very competitive pricing out there not only among warehouse folks but the major retail supermarket chains as well. So prices have lagged a little bit in terms of covering that.

All in all we continue to see a good showing in gross margin line with nice increases in three of the four core sub categories and good increases in gas margins as well. The impact from growing our executive member business which results in higher 2% rewards as you saw jumped three basis points.

The implication there is that sales penetration of rewardable merchandise was up about 1.5 percentage points.

LIFO, last year in all four quarters we took LIFO credits I think totaling over $30 million pre-tax for the fiscal year 2009. This year now that we're essentially, you can't go below zero the way I can describe it and even though there's been slight deflationary trends this year that's starting to switch but nonetheless slight deflationary trends you can't go below zero so there's no LIFO charge or credit in Q3 compared to a $6 million LIFO credit last year. So that was a four basis point detriment to this year versus the comparison of last year. This is one of those items I mentioned early on in terms of the pluses and minuses in looking at the Q3 year over year comparison.

Now after taking all of this gross margin information in perhaps the easiest way to summarize Q3 over Q3 gross margin comparisons is that excluding gasoline sales year over year Costco's gross margins would have been up in Q3 by five basis points and this is notwithstanding the minus three basis point variance year over year from the 2% reward and the minus four basis point variance from LIFO.

Moving on to SG&A our SG&A percentages in Q3 over Q3 were lower or better by 40 basis points coming in at that 10.29% of sales this year compared to 10.69 last year. Again I'll ask you to jot some numbers down then try to as best I can explain it here. These line items would be operations, central, stock options, quarterly adjustments, total and again looking at the three columns it would be Q1, 2 and 3.

In operations its minus 16, going across and minus means higher or bad, Q2 is zero, and Q3 is plus 14. Central minus 3, plus 2 and plus 4. Stock options or actually compensation now that we do RSUs, minus 3, plus 1 and plus 5. Quarterly adjustments plus 18, minus 12, and plus 17. Total minus 4, minus 9 and plus 40.

So let me give you a little editorial here, so looking at the first thing core operations was lower or better year over year in Q3 by 14 basis points and its all about sales mix change, just like with gross margin percentages, where increased gasoline sales penetration hurt us it caused, honestly helped SG&A by about 22 basis points.

So the plus 14 minus the 22 if you will is a minus 8. So where is the minus 8 in the core operations, its most higher health care and other benefits related costs. But as I will explain in a minute there seems to be a little light at the end of that health care tunnel. The rate of dollar increases in these benefits related areas increased year over year in Q3 at a rate of increase lower than has been the case in the three fiscal quarters.

I also mentioned that while that was why the plus number went to a minus number one of the positives was the payroll comparison which we are seeing some payroll leverage in Q3 over Q3. Payroll percentages showed improvement of 10 basis points year over year in Q3, pretty good given the relatively low underlying levels of sales growth.

In terms of health care costs, in fiscal 2009, the US health care costs in dollars jumped 26% in Q309 versus Q308, and 27% in Q409 versus Q408. If you recall that's when we started talking about what I call the double whammy. One there's health care inflation and two with the reduction in new openings of warehouses which is where you have a lot of new hires, particularly new part time hires that take up to six months to become benefits eligible.

As we opened fewer warehouses that meant that the mix of employees became more eligible instead of having these new part timers. Similarly existing employees aren't leaving their jobs. Our turnover rate overall which in good times, good economic times a couple of years ago tended to be in the 20% range, is now in the 10% range.

So again we've seen a double whammy which seems to be now anniversarying that we have a higher percentage of our base of employees in the US being covered with health care. So again we began looking at Q3 and Q4 last year as compared to their respective quarters in the prior year we saw US health care costs go up 26% and 27%.

In the first half of this year Q1 and Q2 combined, the increases were about 20% and in Q3 the quarter that I'm talking about right now, as we have anniversaried at least the big increase in percentage of employees who are benefits eligible, our Q3 year over increase in health care costs was a little over 11%.

So hopefully that trend will continue. Our central expense was lower or better year over year in Q3 by four basis points, again a chunk of that is the gas inflation and stock compensation expense was five basis points better. The latter a slightly lower dollar figure on strong reported total sales figures.

Finally the quarterly adjustment line of 17 basis points in SG&A consists of last year's, that component of the $34 million that hit SG&A line about $7 million of that $34 million and this year's $14 million credit for the partial recovery of the Canadian charge taken in 2007. Again that Canadian charge was Canadian taxes to our employees that we protected those employees that received those options up there, that hit the SG&A line not the income tax line.

And then there were about four basis points of miscellaneous items hurting Q3 last year but more on a one-time basis. Overall I think probably in the last couple of years one of our better SG&A performances given the current sales levels and the slowing rate of growth but still escalating costs in health care.

We continue to work hard and we're focused on reducing SG&A. That's a primary focus of Jim and Gregg. Next on the income statement line pre opening expense, $9 million last year in Q3, $3 million this year in Q3 so $6 million or four basis points better.

Last year in Q3 we had five openings, this year in Q3 we had one opening. Also last year in Q3 we had quite a bit of pre opening about half of it expended in Q3 related to several then upcoming openings in international. No real surprises here, it will fluctuate.

Of course pre opening expenses will start to increase as our opening plans for Q4 into fiscal 2011 start to increase. In terms of provision for impaired assets and closing cost line, in Q309 last year we had a charge of $7 million for the quarter compared to charges of $3 million this year. Last year's $7 million charge included a $5 million reserve to cover the closing costs and asset impairments related to the then planned closing of our Costco Home units which actually took place on July 3 last year.

So all told operating income in Q3 versus operating income in Q3 a year ago was up 36% year over year and of course excluding the items noted in the press release that operating income increase year over year would have been up 21%.

Below the operating income line reported interest expense was slightly higher year over year in Q3 and Q3 coming in at $27 million versus $25 million last year. That's actually a little under $1.5 million increase due to rounding, the 27 and the 25. These amounts mainly reflect the interest expense on our $2 billion debt offering that we did in February of 2007 with the amount of capitalized interest in the quarter being virtually the entire reason for that year over year $1 million difference.

Interest income was higher year over year by $4 million, it came in at $10 million versus $6 million a year ago. Interest income was higher year over year, that $4 million delta interest income was actually higher year over year by a million dollars. Rates have not gone up dramatically needless to say but the amount of cash has.

With most of the rest representing higher year over year Q3 earnings from our half interest in Costco Mexico. Overall pre-tax earnings were up 39% in Q3 from $340 million last year to $474 this year. Of course excluding the items outlined in this morning's press release that being the $34 million charge taken in Q3 last year and the $14 million benefit benefiting this year's Q3, pre-tax income would have been up 23% from 374 last year to $460 million this year.

Our company tax rate came in at 34.5% this year versus 37.75% last year. Last year's tax rate had a couple of discrete items that added slightly to the rate whereas this year we had a couple of items that lowered the effective rate slightly. Again the multitude of state, various state and government related tax audits and that will always fluctuate a little bit from that roughly 36.5, 37% underlying number.

For a quick drum down of other topics, I won't be going over the balance sheet as its included in this morning's press release so you have that already. I will mention depreciation and amortization for Q3 it was $180 million and year to date for the first three quarters was $549 million.

As to the balance sheet needless to say quite strong, low debt to cap ratio, accounts payable in terms of us being able to show dramatic improvements and not having to fund a lot of our inventories. On a reported basis last year in Q3 end our accounts payable as a percent of inventories was 102%, this year in Q3 reported was 108%.

That includes other payables in addition to merchandise payables like construction payables. If you look at just merchandise payables to accounts payable, last year in Q3 it was 85% this year in Q3 it was 90%. So again an improvement there, a reflection of finally some small amount of sales strength and very little effective increase in the inventory levels.

Average inventory per warehouse was up $277,000 per warehouse from $10,089 to $10.366 million, or up 3%. Actually that $277,000 figure would only be up $90,000 if you exclude the year over year FX impact of $187,000. So concerns if anything we saw some examples like seasonal patio furniture, the last several weeks we've been scrambling as we sold through that pretty well early in the seasonal season.

In terms of CapEx, in Q309 we spent $226 million, in Q210 we spent $139 million so a little less as you might expect. Year to date we've spent $644 million. I'd estimate that our FY10 CapEx will be somewhat lower than last year's figure probably $950 to $1 billion. That of course will increase and I'll talk about expansion in a minute.

At Costco online as you know in 09 Costco online was down about 4% or 5%. For the third quarter and the third quarter year to date, sales were up 5% in the quarter and 7% year to date. Ecommerce profits were up 7% in the quarter and 14% year to date. So our average ticket has come down a little as you might expect with the fact that we have a very high average ticket because of the items that we sell.

But site traffic continues to grow and was up 9% in the quarter year over year. Like the four walled warehouses on ecommerce big chunk of the business is electronics and again there hasn't been a lot of promotional excitement or lower price excitement on the flat screen side with increased worldwide demand of flat screens.

That seems to be coming to a near end and the sense I got from our GMM in charge of electronics who just yesterday came back from Asia talking to the electronics manufacturers that supplies and hopefully pricing will ease up as we start into the near the end of the summer. In terms of expansion, I mentioned we opened one unit in the quarter. We plan six for Q4.

That would give us a net total of 15 openings, one of which was a relocation so 14 net openings in 2010. In 2011 current construction schedule shows 26 locations including two relos so 24 net. Now I'll mention before I go into fiscal 2011, I'll mention that the Q3 end our total square footage, some of you have asked for that, stood at 76,190,000 square feet for the retail space.

Now in terms of expansion planned for 11, currently there are 24 projects, net new projects active on the current construction list. Nine of these are planned for months 11 and 12 of that year but they are active real projects.

So my guess is is that the figure for 11 will ultimately be around 20 to 22 including 7 or 8 outside North America as we've ramped up some of our Asian expansion.

Lastly I want to talk about our stock repurchases which we began after buying nearly $5 billion of stock between July of 2005 and into the last summer of 2008 before the market went to heck and the concerns about liquidity in general became a major concern. So again we purchased quite a bit back then, during the week of February 8 which was the last week of our fiscal second quarter we got back into the market buying about 250,000 shares that week or about 15,000 a day. During the 12 weeks of Q3 we purchased 1,925,000 shares. Now there are two or three weeks, there were several weeks that we were in black out where we did not buy any.

On the days that we did buy we bought about 60,000 shares a day as compared to 50,000 during that last week of Q2. During the first couple of weeks of Q4 we've averaged 100,000 shares a day and that's principally a reflection of what I've stated in the past. We've got an analysis that we update on a periodic basis and generally speaking we're not trying to be perfect in deciding when to buy but as the stock shows a little weakness in the market, not related to us but in general, we buy a little more.

And when they show strength we buy a little less but overall we've been a net buyer. With that, again there's supplemental information that will posted on the Costco Investor Relations site right away, within the next hour, you have the balance sheet, the other stuff in there relates to the quarterly LIFO items, the actual calculation of EPS to show you the little components of it to do your fully diluted calculations and the like.

With that we're ready for Q&A.

Question-and-Answer Session

Operator

(Operator Instructions) Your first question comes from the line of Robbie Ohmes – Bank of America

Robbie Ohmes – Bank of America

One question I was hoping you could talk a little bit more about the executive membership program and I think you said its one third now where do you foresee that potentially going, if you dreamed the dream where you think executive membership could get for you and then just the second question unrelated is can you just discuss what the current expectation is for food inflation for you over the next six months.

Richard Galanti

In terms of executive membership and the assumption is is we're not just doing that executive membership and I'm not implying anything by that, there have been no discussions its at what point do we say hey we're only going to offer an executive membership. That has not been discussed. But I guess my personal biggest surprise has been the ongoing increase in penetration even in the most mature country US where we've done it for gosh, eight or so years now.

And the good news there is is the incremental increased penetration has very little if any adverse selection. If you think about it, who was the first member to sign up for this, 7, 8 years ago? It was the owner of a restaurant or a convenience store that's already buying $25,000 or more dollars of membership rewardable merchandise and so for doing nothing other than paying an extra $50 or so dollars they get a check at the end of the year for $500.

Needless to say all those people have done this for a long time. Today if I had to profile the member who is opting to convert or opting to sign up as an executive member its somebody that who's likely annual purchases are more towards the break-even of this program, in other words $50 extra divided by 2%, they have to buy $2500 a year in rewardable merchandise.

And those are people that on an affinity basis look at affinity program and are incented to buy more so even though these are smaller and its an increase I'm surprised they're continuing at the levels that they are and I think that's good news.

Keep in mind also in the last, we've had US for the longest period, Canada has probably been gosh three or four years now, and the UK and Mexico, although Mexico we don't consolidate so they're not in these numbers, in the UK we just started it about six months ago, not a big number yet but again its UK is, we're just ready to open our 22nd unit so 22 units out of 500 plus so I think it will continue.

The other piece of that is that if you go back a couple of years ago, for every 100 new member signing up we tended to get 10 or 12 to actually sign up originally as an executive member. Today that number is in the low to mid 20's and I think that's partly because we do a better job at the counter if you will when somebody is coming in to sign up explaining the virtues of it.

So all those things bode well. These people shop more frequently, they buy more. Those that convert once they convert they buy at an increasing rate as compared to the control group and so all that's pretty good. In terms of food inflation in polling buyers in all merchandise categories, a couple of weeks ago the general view is over the next six months, there is inflation but not a lot and I think that their view was somewhat influenced by rising oil prices and rising freight costs and manufacturing costs and that has subsided in the last couple of weeks.

But if you ask them today they're still going to say a little bit of inflation. Fresh foods, whether its meat, produce, there's all kinds of anomalies that impact inflation and deflation there, not just the economy. But overall I would say some, 1 or 2% and then that is tempered a little bit at Costco because of the deflationary trends related to increasing penetration of private label. So very modest inflation.

Operator

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

Mark Miller - William Blair

On the multi vendor mailings what's been the net impact to sales and also margin year to year, I understand in April there might have been less couponing which hurt the comps and I think you were going to try to take some action here in May. I'm also curious whether that has helped the business this month.

Richard Galanti

By the way the action is more of a timing issue. I think on a fiscal year over fiscal year basis its maybe 31 versus 33 weeks or 33 versus 35, it's a couple of extra weeks. As related to April and Bob's comments on the monthly call, that had to do more with timing of a given mailer where one started earlier last year and so we benefited a little, hurt a little one month and benefited a little the other month.

The big issue with MVMs is if you go back a year ago or a year and a half ago, there was always 3 or 4 or 5 items that were $1000 TVs, or $1200 TVs with a $300 off or $900 for $200 off as well as a little less of an issue but the same thing on PCs or laptops. Again right now there's very little of that. So I don't have the exact dollar numbers. There's probably been a slight less on a per week basis dollar amount of sales from the MVMs but also people are pushing more basic household goods where again when we talked about on a monthly basis some of the non-foods categories that have been in the low to high teens comps, some of those are influenced by some of the items you see there.

There's lots of $30 to $80 items in the MVMs whether its, I don't have that one in front of me but things for the home and but not the $1000 items and so that's part of the impact there. The view is is that will start to lighten up near the end of the summer in terms of being able to offer some promotionals but there's no guarantee.

Mark Miller - William Blair

My other question is on the gas operations what actually was the year to year EPS benefit to you in the fiscal third quarter and then we've found that the gas price advantage for Costco seems to have widened versus competitors maybe $0.03 $0.05 per gallon over the last six months, it's a question about has your gas price per gallon and it looks like its widened versus the competition over the last six months, if we're correct on that has that resulted in better comp gallons and then with the big drop in oil can you remind us how its impacting the business. You turn the inventory faster would you be seeing a bigger benefit to the bottom line or would you be putting that into more aggressive pricing.

Richard Galanti

In general gas is one of those things that its like a teenager, you love them but they drive you crazy sometimes. In the quarter year over year there was a small benefit less than a couple of cents, maybe a couple of cents at most, $0.01 to $0.02, I think around $0.02. But usually we don't talk about that other than when it's a big delta.

In terms of the gap of $0.03 to $0.05 are you suggesting that our prices compared to our competitors that gap has spread.

Mark Miller - William Blair

The gap has widened as we looked at it.

Richard Galanti

I don't see that, I think that may be more regional but all I can tell you is is we [inaudible] shop our gasoline in some locations two or three times a day versus the direct competitors of Sam's or some of the discount stores or supermarkets and at least once a day in all locations. So we feel we're very competitive.

I assume we're all making more money this week versus two or three weeks ago as gas prices came down. That's good for us so we entered Q4 positively. Although we made a decent chunk of money in gas last year in Q4 and what I've learned is is even though we're 2.5 weeks into Q4 I can't extrapolate for 16 weeks. As soon as you bring out the party frills something happens and gas prices go up and oil prices go up and the profitability is tempered some.

But we're starting off well.

Mark Miller - William Blair

The other small question in there was the change in the comp gallon trend, has there been any.

Richard Galanti

The gallons are up. I don't think there's been, if anything last year the trend was flat a little bit and its improving a little bit this year. Where we saw a big comp gallon change was in 08 when prices went through the roof and people were talking $4 gallon gas during the spring and summer of 08. That's when we and I'm sure some other warehouse clubs but virtually in every market in the country whether it was Mazoula, Montana, or Los Angeles when the local TV consumer advocate was on the nightly news talking about where's the cheapest place to buy gas we benefited greatly from that and we saw gallons go up dramatically as people were trying to save money.

That is not as big an issue now but we're still seeing some, so as prices fell dramatically again it was flattish and now its up a little.

Operator

Your next question comes from the line of Charles Grom - JPMorgan

Charles Grom - JPMorgan

I just want to go in to the gross profit to make sure I understood I heard you correctly, so the total is down 11, if you look within core you're down 10 but I believe you said the core I guess within the core was up 14, is that correct so you're within the 4 the 80% of the businesses was up 14.

Richard Galanti

Yes, that's correct. If you think about it and these are not exact numbers I'm just doing this the back of the envelope here, if you assume that the core relative to gas has 800 basis points delta and you have 800 basis points and a little over two percentage points of reduced sales penetration of that higher margin stuff the core, 2.25 or 2.5 percentage point, about 2.3 of penetration difference times 8 or 900 is 20 basis points.

Charles Grom - JPMorgan

So that 14 compares to the plus 5 a year ago, right.

Richard Galanti

Yes.

Charles Grom - JPMorgan

That's a plus 19 versus a down 3 last quarter, so I'm just trying to get a sense for what changed within the quarter led to such a big improvement, was it mark up rate, was it IMU, was it lower mark downs.

Richard Galanti

I think it's a little bit of everything. Its higher penetration of fresh foods, its slightly lower what we call D&D, its an improvement in our sales returns reserve a little bit which impacts the margin through the salvage estimates. It really is a lot of little things. It not like we sat around the table 12 weeks ago and said how can we improve margins more.

There's generally a trend that margins are not the issue that we can show some improvement and still be competitive and Bob Nelson is sitting here saying well you and I did, yes, but we're not the merchants. But the fact is is that it is a lot of little things.

Charles Grom - JPMorgan

And then just moving down the P&L interest income in the second quarter was $30 million, this quarter I believe it was $10 your cash balance increased so I'm just trying to connect the dots, is that just lower other income coming from the JV from Mexico that led to the—

Richard Galanti

Interest income was $10 versus $6.

Charles Grom - JPMorgan

Last quarter was 6.

Richard Galanti

Sorry last quarter—

Charles Grom - JPMorgan

I'm looking at sequentially. It was down $20 million sequentially. It's a pretty big drop off.

Richard Galanti

I need to find out what it is, I just don't have it in front of me. I'm happy to call you with it.

Charles Grom - JPMorgan

If you looked at cash and short-term investments per share you're sitting at I think an all time high of $12, it sounds like you're starting to buy back stock but is there any other plans to utilize cash in any other way, can you get a little bit more aggressive on the buyback, you're sitting with a lot of cash.

Richard Galanti

My comments a minute ago imply that we are more aggressive. We are more aggressive in the latter part of Q3 than the beginning of Q3. We are more aggressive in the first two weeks of Q4 then all of Q3 or the latter part of Q3 so yes, more aggressive there. In addition my guess is $900 million of the $2 billion debt was five-year money that comes due in March of 2012 which is now only less than two years away. We'll write a check for that.

So there's $900 million that we'll spend and CapEx should ramp up nicely in 2011 and 2012 compared to the roughly a little over a billion in 8 and 9. So those are the three areas that I would see.

Operator

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

Mark Wiltamuth - Morgan Stanley

If you look at the average of the monthly comps you've been announcing for the US business that 3% ex gas number that you posted this morning for the quarter that implies that the stub of the first nine days of May may be up, can you maybe comment on that a little bit. So the average of the three monthly numbers that you've released already comes in below the 3% comp that you referred today for the US business excluding gas and I'm wondering if that implies that the first nine days of May is trending above what you did on those April numbers.

Richard Galanti

It's a little bit of an anomaly because our quarter is like February 10 or so, February, March, April so we didn't get anything for May, but you're saying the implication is it's a little better. I'd have to look at the numbers. I don't think there's any major change either way.

Mark Wiltamuth - Morgan Stanley

And then also if you give us a little update on what's going on competitively out there, Wal-Mart is getting more aggressive on roll backs, we're starting to see that roll into the beverage area a little bit are you feeling any impact from that or can you see it at all in your stores.

Richard Galanti

We have not seen it but it is top of mind discussion every day around here and the merchants are out there looking recognizing we're less impacted by what Wal-Mart is doing versus what Sam's is doing. And Sam's has always been very competitive as have we. They are taking certain items down dramatically and there's certain items I'm not going to say which ones that we have taken down to cost, very small number by the way.

And we'll do what we have to do but overall that has not really been a big impact to us. I think it's a much bigger impact to supermarkets and general merchandise retailers.

Mark Wiltamuth - Morgan Stanley

And on the quarter here part of the margin performance you posted was a much better SG&A control effect you said this was one your best SG&A controlled quarters in some time, is there anything you can point to specifically that you're doing that we could give us some comfort that that trend will continue or is it just lapping some of those health care problems.

Richard Galanti

Well the health care is lapping but all the health care and related benefits costs were still a detriment but a much lower detriment in Q3 over Q3 as compared to Q2 over Q2 or Q1 over Q1. I think payroll is the biggest one. I think we have in the last year we've reduced the average SKU count which means we still have the same square footage so we're just maxing out and are more efficient in what we are selling.

We have gone back and I've used the comment that for many years I'd always say well there's not a lot of silver bullets because we're pretty efficient. But in tough times one gets more efficient. And everybody out there I think is working a little harder and even the little things we're doing whether it was changing out the color copiers to, you have to opt in to color, I use that example.

There's lots of little things. There's no big giant changes out there in the warehouse other than a focus a renewed focus on expenses.

Operator

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

Adrianne Shapira - Goldman Sachs

If we could just continue on that line of the expense control, it looks as if that 10 basis points of payroll leverage is quite good, could you remind us what happened with the renegotiations of the contracts what that implies in terms of leverage opportunity going forward.

Richard Galanti

Every three years, which the three periods are most recently was March of 2010, we rewrite our employee agreement. Its not a contract its actually an employee agreement that we send to them on the 60 locations out of 500 plus that are union, that is a contract but its very similar to what you see in the employee agreement for the non union employees.

And the question if you go back a year ago that with the economy bad what happens to top of scale which is about a little over half of our hourly employees are at top of scale, what type of increases are they going to get each year. Basically very little change from prior years and if you look back in the last two or three year employee agreements, so 2007 to 2010, 2004 to 2007 and so on, once they are top of scale they rise pretty quickly from when they start here over those first 4 or 5 years to get to top of scale with big increases each year.

Once they hit top of scale historically its been somewhere around 2.5% increase so rough number at top of scale was $20 you assume, $0.50 an hour would be 2.5% increase. We went into it discussing things but generally speaking we felt this was an important time to continue that when employees are in need. And so there’s not a lot of benefit to their bottom line from say hey we can only do half as much because we chose to do as much.

I think where we’re going to see a benefit on the labor side is we have great employee relations. I think we’ve seen some of the improvement in payroll percent is is that people get it and they are working harder and smarter. I think also if we get a little leverage from sales that will help. Where I think the opportunity is going to be is some actions that we can take on the health care side.

That’s a big nut. Its growing, forgetting about the increased number of people eligible because of slowing warehouses that will improve as we ramp up warehouses a little bit. But more importantly making our employees better consumers. We’re not going to do take aways but we like a lot of companies are looking at a lot of things like I give you a simple example, in the greater Puget sound let’s say there’s 20 places, hospitals, medical clinics, where you can get a standard MRI, mammogram, or colonoscopy, those are three major items.

The contract negotiated large company here rates could range, there could be a four full delta between the cheapest and the most expensive in a community. Now we’re not going to just say you can only go to the cheapest but its been structured so they can go anywhere and there’s got to be some rationale there that something that costs $1000 in one hospital and eight miles away in another well known hospital costs $2800.

We're not doing anything that other companies aren't doing but we're looking at all those types of things and we think we can save money and to help control that a little more.

Adrianne Shapira - Goldman Sachs

Okay so just to be clear on the employment agreements no change, it had been, I guess we were calling it out as perhaps a BB not a silver bullet but an opportunity but it sounds as if no change there.

Richard Galanti

Correct.

Adrianne Shapira - Goldman Sachs

And then just talking about on the you had mentioned on the earlier question a small number of items you priced at cost can you just perhaps dig into that a little bit, I know not that long ago, a year ago you got a jump on being quite aggressive and we saw traffic picked up but we also saw the impact on margins could you give us a sense as you talk about Wal-Mart as top of mind and top of center around the discussion around there with as it relates to the roll backs, what would be sort of the tipping point in terms of getting more aggressive like we saw last year.

Richard Galanti

Well first of all last year which we were talking about is essentially December of 2008 when commodity prices had fallen precipitously but the underlying commodities from vendors were lagging four to eight weeks. And we chose to given the comps were heading towards zero and we chose to basically take it upon ourselves about $30 to $35 million in commodity markdowns on a limited number of items but in the aggregate $30 to $35 million, rotisserie chickens, milk, cheese, butter, to drive traffic.

We saw an improvement in frequency. And that was the perfect storm as I described it back them because we knew that it was a matter of weeks not months or years where the underlying procurement cost to us would come down and fall in place but that's hurt us because we didn't get price protection on that.

I don't see any current scenario that dictates that. Again Wal-Mart is amazing at what they can do and what they're doing right now but a lot of that's Wal-Mart versus supermarkets not Sam's versus Costco. I think we and Sam's and BJs but we and Sam's in this regard are fiercely competitive and have always been. I think we both know that if one of us gets aggressive the other one's going to be equally aggressive and arguably we've got Jim and we're aggressive.

And I don't see that as a current issue. Things could change tomorrow but we're going to hold our stand here and but there's nothing in today's tealeaves that tell me differently.

Adrianne Shapira - Goldman Sachs

And the items that are down to cost in terms of could you be a little bit more specific in terms of categories where they are.

Richard Galanti

There's one, I heard one example yesterday in a meeting and it wasn't a meeting on Wal-Mart it was a meeting on a lot of things and there was one item in health and beauty aides where they're selling it below cost. And we've taken it down to cost and its one little item. I don't want to say what it is. But its meaningless to the company other than I'm sure there's some other things out there but we are, let's face it we and Sam's are fierce competitors and respect one another and we both also have pressure to make money.

And I think that we'll hold our own here.

Adrianne Shapira - Goldman Sachs

And then on California an update there in terms of what you're seeing.

Richard Galanti

Again at a lower base but quarterly sequence or the last four quarters have been good including Q3.

Operator

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

Peter Benedict – Robert W. Baird

Quickly the third quarter buyback how much money did you spend to buy those shares back.

Richard Galanti

It was $114.6 million.

Peter Benedict – Robert W. Baird

And then the D&A growth I think you said it was $180 million so the growth was about 5% year over year that was a big step down I think in the second quarter D&A was up 15% year over year, is that correct and if so is it just a slow down in the clubs and its seems like a pretty steep drop off, is that what we should be thinking going forward.

Richard Galanti

I think its more then anything timing of openings. I asked the same question this morning when I said sequentially it looked like it was a little less of an increase in Q3. Its just timing of a few things. Nothing dramatic there. Once we ramp up expansion. I think part of it also is we had committed a little more over the last year to IT which has three and five year write-downs. So nothing earth shattering there.

Peter Benedict – Robert W. Baird

And then just on private label can you give us a sense what the penetration was in third quarter versus last year.

Richard Galanti

Penetration year over year is up about a little over 1.5 percentage points, about one percentage point, maybe 1.25.

Operator

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

Robert Drbul - Barclays Capital

You talked about a lower SKU count in the store, what's the current number that you're operating with.

Richard Galanti

SKU count is 3750.

Robert Drbul - Barclays Capital

And is there a plan to change that or take that any lower from where you are today.

Richard Galanti

I think we're comfortably low right now. Keep in mind probably four years ago it was when the stated goal internally was 4000 it was inching towards 4200 when Jim every monthly budget meeting would say, guys would you like me to do it or would you like to do it would you like me to do it, I can take about a half an hour.

And then the feeling was is is the top 200 items or 5% of the items represent darn near 40% of the sales you can imagine what the bottom 200 and let's mass out and we'll do more volume so I think that we feel comfortable where we are right now.

Robert Drbul - Barclays Capital

Are there any new brands or in different categories that you're excited about, things that you're selling now or you're looking to get that you can talk about.

Richard Galanti

I think in terms of there's certainly I'm sorry I just don't have, I missed that one, so I don't have that list in front of me, I know there's more brands in apparel and more availability of some apparel. There's, in terms of the KS I think between now and the end of the year and into next year look for some more branded private label items in lots of supermarket consumables, canned goods and things like that.

And I think in the last six months you've seen things like KS macaroni and cheese and the like and so both dry and canned foods. Electronics I think again 3D will happen. I'm not sure everybody is going to jump on it the first day but we'll be there. LED backlit, there's some things there that are kind of exciting on that side. But I'm stretching here.

Robert Drbul - Barclays Capital

And so when you look overall at the trends when some of these are naming but discretionary versus non-discretionary where do you think we are from a consumer perspective today.

Richard Galanti

I think that the biggest change from now versus 1.5 years ago was the fact that as TVs, as flat screens went from $2000 to $1500 to $1200 and $900 and $800 to $700 demand units were up huge and finally there's been sated a little bit their appetite. As well with increasing demand worldwide like in China and India and what have you, is what I'm being told, that for the first time in a long time over the last few months the underlying cost of the panels, the OEM cost of the panels was up dramatically.

And so there's not a lot of promotional money to do the MVM and things like that so not only do you have price deflation in some of those categories over the last couple of years you've got a little less demand than you had historically. I think that being said I think what is a positive price. We went into this season for patio furniture which we sell between January and March, a couple of months before the season starts and want to be out a couple of months before the season ends, we've been scrambling, probably by mid March we were scrambling for extra inventory because we while we were a little conservative committing this year not a lot conservative but a little conservative we sold through it very well.

So whereas people my favorite article that I read about all this was called Frugality Fatigue. People were frugal last year and some of them are a little tired of being frugal. And they're buying things for their home and whether its door mats or housewares or coffee machines or live goods, plants, that's stuff that's been strong.

Operator

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

Laura Champine – Cowen & Company

I know that you can appreciate the difficulty for us in forecasting gas as net impact on your gross margins and you cited some changes in penetration but pretty good gross margin on gas itself now but do you think that gas will have a more or a less of an impact on company wide gross margins in Q4, what's the trend right now.

Richard Galanti

I think it will be a slight, a lesser negative. You're still going to have year over year inflation in gas and so that penetration of lower margin, you'll have better margins probably year over year but not as great as I mentioned here in Q3. A year ago in Q3 we lost a little money, this year we made a little money. Last year in Q4 we made more than a little, not a huge amount but more than a little. We're entering this quarter pretty good.

So let's assume we do a little better than last year bottom line wise or therefore gas gross margin wise I'd still, the increasing penetration dwarfs it.

Operator

Your next question comes from the line of Deborah Weinswig - Citigroup

Deborah Weinswig - Citigroup

Can you talk about what you're seeing in terms of spending my small business members.

Richard Galanti

Our sales penetration all I can tell you is the sale penetration has been fine. There's not been any dramatic change. I think one of the issues for us has been over the last year when we saw everybody talked about restaurant businesses down, well first of all restaurant business was more down for the bigger restaurants, the higher end restaurants which is not necessarily our customer.

And then in the case that restaurant business was down who benefited, supermarkets and warehouse clubs. So I think we had some offset there.

Deborah Weinswig - Citigroup

And then if you were impressed with higher traffic on top of difficult comparisons can you talk about what the basket looks like.

Richard Galanti

When I go out there it's a lot of foods and sundries. There's fewer TVs in the basket and not a lot fewer but fewer and again I think we have become, if there's a silver lining to this horrible economy over the last year and a half is that the warehouse clubs and us in particular or the extreme value proposition one of signature categories in our view is fresh foods.

People are shopping with us more frequently than they used to. Some of that is restaurant business and my view some of that is supermarket business that people are getting more of their stuff at Costco.

Deborah Weinswig - Citigroup

So are they shopping more frequently but the overall ticket is less.

Richard Galanti

Yes.

Deborah Weinswig - Citigroup

And then can you talk about international performance.

Richard Galanti

Again as I mentioned the UK comps were close to flat. Every body else is in local currencies is quite strong. Canada is the one that is most impressive from the standpoint in my view from the standpoint that its 70 or 80 units its almost as old as our whole company operation, and so relatively mature and its showing 10% comps in local currency.

Deborah Weinswig - Citigroup

And how should we think about international margins.

Richard Galanti

Positively.

Deborah Weinswig - Citigroup

I just wanted to confirm that the target rate for private label is still 37%.

Richard Galanti

I think it is but that when your children go to college, directionally yes but its going to take some time and I clearly as I get into the remainder of the calendar year we'll be able to talk more about some of things like some canned goods and some other items recognizing we tried a mayonnaise two or three years ago and a peanut butter and we underwhelmed you so not everything works but most things do work.

And there's not a whole lot of sacrosanct in terms of branded goods. We want to offer both, we want to show our member the quality that we can offer and clearly if we can get them to be loyal to the KS brand that's great long-term and we're pretty much prepared to try everything.

Deborah Weinswig - Citigroup

Based on the average household income of your member have you been surprised at the up take in EBT as a form of tender.

Richard Galanti

No, I think its positive. Its still small, a very small percentage. I think it rounds to 1%. But I think we looked at ourselves in the mirror and said we probably were a little bit of, a little arrogant not, for a long time we didn't do it for whatever reason and even though technology wise it got a lot simpler and it did not have any real impact to the front end in terms of slowing up the lines and in our view that it really isn't our member, well the reality is its everybody's member and if it can help and its not very costly to do, which is the case, then it's a positive, it's a slight net positive.

Operator

Your next question comes from the line of Colin McGranahan – Sanford C. Bernstein

Colin McGranahan – Sanford C. Bernstein

Quick follow-up on two topics that have been discussed already on SG&A you gave us the cadence of the growth rate of health care and I know some of the things you're looking at in terms of making your employees better consumers those are kind of long tailed, do you think that the 11% growth rate now is more of a steady state growth rate for some period of time or should that continue to inch down as the compares get a little easier still.

Richard Galanti

I think that on the one hand there are things, first of all the long tail is not completely long, this is not like smoking cessation programs or weight loss programs or exercise more and eat better so you'll have less heart attacks 10 years from now, this is some of these changes can be made in the next year and each one can be a few million bucks so its not giant but it will all help.

The offset to that is changing health care legislation and not just the new plan, one example next year and this is I don't think this is even part of the what's referred to as the Obama health care plan, is that currently dependents of employees who are under 22, under 18 or under 22 if they're in college can be on their parents health care plan.

And you'll say there's a cost to that to the employer. The new law is that, I think it goes into effect either January 1 or September 1 based on the fiscal year but I think its January 1 the new law is up to 26 and you don't have to be in college. If we look at our current employee base in the US of 95 or so thousand people, existing employees who have dependents in the plan but based on their age they left our plan either at 18 if they weren't going to college or 22 if they were going to college we have about 13 or 14,000 people out there that have left our plan of current employees.

Not all of those are going to jump on our plan. If they're working themselves and many of them are if they're eligible for their own plan they can't go on our plan. But let's assume half of them do, that's 7000 and they're young and they're healthy but even if the average cost was only 2000 there's $14 million a year.

So there are things that will mitigate some of the savings. But nonetheless I think that I can't guess I would expect the growth rate in dollars in Q4 given that we had a high increase last year in Q4 is around the same or a little better and hopefully gets a little better but its still going to be in at best in the high single-digits going forward over the next couple of years.

Colin McGranahan – Sanford C. Bernstein

And then just follow-up through the quarter and really focusing on the US business the average ticket didn't really kind of improve maybe as much as we might have expected it to and I know you've talked about more frequent trips still happening but any other thoughts on that. I would think that with the discretionary categories are showing a little bit of life that maybe that average ticket trend should be getting better faster.

Richard Galanti

Well keep in mind they are coming in more. They're buying a little less each time and also they're buying more food and sundries and less $1000 TVs. That goes a long way to changing that average ticket a little bit. I think we're probably half to a little more than half, or a little less than half way through a year cycle in that in terms of the pressure of less TVs.

If you go back a year or two or three years ago one $1000 television in our MVM in two or three weeks we could sell 20 or 30,000 units or $20 or $30 million of one item. There are none of those right now. So those are things that impact it. Now is it offset by coffee makers and toaster ovens and exercise equipment and a lot of other things, yes, we're doing a pretty good job of fighting tackling.

My view is a simple one is is that we got them coming in more frequently and its not like they're buying it somewhere else. When they start buying they're buying it at us.

Operator

Your next question comes from the line of Neil Currie – UBS

Neil Currie – UBS

I wonder if I could ask a follow-up on that question earlier about average ticket and you mentioned consumer electronics and selling less TVs, I think we spoke in the past and you've talked about how there's been more of a shortage of big TVs and that's led to better pricing potentially but lower sales, I just wondering if you could give us any view on how that's going to change over the next six months or so, whether you see more new TV models coming into the system, whether that we should start to expect TV sales to start going up again.

Richard Galanti

The big issue over the last four to 10 weeks let's say has been less promotional opportunity for us in MVMs and arguably less offset a little bit by less deflationary trends in there. Again our VP of majors and electronics literally just got back yesterday from a week in Asia meeting with all the manufacturers and the view is is that availability will be greatly enhanced by mid or late summer.

That the capacity is up and so there's a feeling going into the seasonal parts of September through Christmas there'll be a little bit more promotional opportunities and I hate to use the word promotional but let's face it when you have something that's been declining on its own $200 or $300 a year and on top of that a couple hundred, $300 three week $300 off in an MVM mailer that drives business and again there's not a lot of that excitement in the MVM mailer related to those bigger ticket items right now.

Neil Currie – UBS

So you think in the first quarter or so we should start to see them coming back in the MVM mailers.

Richard Galanti

Four months from now in early October when we talk about Q4 we'll talk about it was still an impact in Q4 but near the tail end of Q4 and into the first month of Q1 of September we see a change. That would be my hope.

Neil Currie – UBS

Why is the UK so flat against other international markets, is it just economy based or is there something else going on in terms of—

Richard Galanti

A little bit of it has to do with in the UK we operate under a slightly different format and if you walk in it's a membership warehouse club. It looks like a warehouse club, it smells like a warehouse club, and it walks and talks like a warehouse club. The one difference there is is that in order for us to make economic sense we locate our facilities in what are called commercial trade areas, not retail areas which are still expensive but not as expensive and are more available.

Because of that each and I forget if it city, states, provinces, but each locale has a minimum required of business to the trade so we do not market nearly as strongly to non trade members or non business members. So we have less of a consumer piece over there. And so that always has impacted us a little bit over there.

Neil Currie – UBS

Basically what you're saying is the business community there isn't recovering.

Richard Galanti

That's my guess, I can't—

Neil Currie – UBS

[inaudible] into the consumer any consumer recovery.

Richard Galanti

Our view is is that our pricing is more favorable over there relative because there aren’t other warehouse clubs over there and discounting is not as dramatic. But again the economy I’m not an economist I don’t have the numbers in front of me for the UK, my guess is it’s a little bit of a small business recovery but also the fact that how we after market.

Neil Currie – UBS

Any thoughts on the west coast, any changes you’re seeing to California economy in particular.

Richard Galanti

Again I think that sequentially we’re seeing it pick up nicely. Its still at a lower rate then some of the other parts of the country but I think, we’re all looking for tidbits every week or every day when you hear something about finally there’s a reduction in the foreclosures or but the fact is again I think the frugality fatigue helps a little bit and but we are seeing a little pick up and there’s at least not the concerns of the sky is falling.

Operator

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

Dan Binder – Jefferies & Co.

Question on membership growth going forward, you’ve had a nice little acceleration off of lower levels in prior quarters how would you expect that to play out in local currency over the next couple of quarters, still at that 7% level or does that start to get a little bit better do you think. The question was regarding membership growth its shown some nice improvement in local currency in the last couple of quarters and I was just curious what you’re thoughts were over the next couple of quarters, does it maintain this 7% rate or so or do you think it can improve off that level.

Richard Galanti

I would hope it accelerates somewhat because we're going, we're opening one unit in each of the last two quarters to six in Q4 and God willing around five or six a quarter in all the quarters next year recognizing whatever, so that should be an improvement, an acceleration recognizing any acceleration in terms of the P&L we record membership fee income on a deferred basis so if you get an incremental new member tomorrow at $50 its basically $4 a month extra incrementally into the next 12 months and so that will temper that rate of acceleration.

Dan Binder – Jefferies & Co.

And through this earnings season we've heard retailers talk about some softness or choppiness related to weather in May and obviously we've had a lot of turmoil in the markets over the last few weeks and I realize comps are next weeks, but I'm curious are you seeing choppiness or volatility or any increased volatility in your business over recent weeks as this has unfolded.

Richard Galanti

The only choppiness that we see relates to how a holiday falls like Memorial Day fell a week off so it helps you one week hurts you the next week or vise versa and the timing of an MVM mailer where if I'm making this up but let's say last year it was weeks one through three of a month and this week its weeks two through four, in week one this year since you had an MVM last year but not this year you see sales down and in week four it catches back up.

Dan Binder – Jefferies & Co.

And then just some housekeeping items but do you have an expected tax rate for the full year and I was just curious where you think pre opening and net interest will fall out for the full year also.

Richard Galanti

Well pre opening should start to escalate some, I'm sorry I don't have that in front of me, but that should escalate for more spend, more openings, and interest income, by the way getting back to I think it was the question on Q2 interest income, the big delta in Q2, interest income I looked at my notes from Q2 and interest income actually was only up a few million dollars year over year in the quarter.

The big difference sequentially that you had mentioned was related to first of all Q2 has Christmas and Mexico our half of Mexico earnings are dramatically higher then and in addition as I mentioned in the Q2 conference call we did pick up some incremental dollars on FX contracts. Usually that's something that's no more than plus or minus a couple of million dollars and I never talk about it.

We happened to have in Q2 a benefit of probably a penny, $7 or $8 million and so that was an anomaly in Q2 that is more of an anomaly whether it was a plus or a minus in Q2 it was nonetheless an anomaly. And the other big chunk was just quarterly profits in Q2 in Mexico were dramatically different than Q3.

But looking into Q4 I don't see a big change, again it doesn't matter how much cash you have and it ain't a whole lot of money, given that we know that we're going to pay off $900 million in March 2012 in the last few months we have taken about $900 million and extended it out up just under two years and are making an extra 80, 90 basis points so say $900 and 80 basis points is $7 million a year.

So maybe annualized you'll get a couple million a quarter from that but that's not earth shattering.

Dan Binder – Jefferies & Co.

And the tax rate for the full year.

Richard Galanti

I think our tax rate, I start every quarter with a tax rate assumption of around 37 or high 36's, and usually its between again the percentage in Q3 which was 34.4 part of that is is Q3 is a lower profit quarter. So when you've got a $3 or $5 million benefit or hit in a quarter on a lower percentage that changes the percentage more on a lower base.

Operator

Your final question comes from the line of Damian Witkowski – Gabelli & Co.

Damian Witkowski – Gabelli & Co.

Just going back to your comments on regional strength any sense of what percentage would you attribute or just what's is it the region improving or is it that you're just taking share in those regions.

Richard Galanti

I think in the Midwest and Texas a little bit has to do with we're newer there. I almost can't say newer anymore because we've been in those regions now for 10 or so years, but we're not there for 25 years. I think Texas again we've been there for 10 or so years and our competitors have been there for 25 years. I think we just are showing some nice improvement there.

In Florida or southeast which is Florida, Georgia, the Carolina's, I think its half-and-half. I think some of it we're taking market share because we've done a pretty good job and some of it we have some newer units.

Damian Witkowski – Gabelli & Co.

And then you haven't seen the northeast mentioned in the few quarters here I think now as a regional strength and is it just because of the fall as far and so it has less room to improve or what's happening in the northeast.

Richard Galanti

That’s correct but in addition northeast I forget which quarter or which months it was but they had hard weather patterns. And I hate to use that as an excuse but I know there were a couple of months there a few months ago which really impacted it.

Damian Witkowski – Gabelli & Co.

And then are you finding it harder now to find to buy in better deals and if so what categories in particular.

Richard Galanti

The only one that I’ve heard about is that, is the TVs. Again there’s not as many deals out there because of a worldwide increase in demand and again that seems to be finally abating a little bit over the next couple of months. Other then that and there’s plenty of deals out there.

Thank you everyone, have a good day.