Costco Wholesale Corporation (NASDAQ:COST) Q1 2017 Earnings Conference Call December 7, 2016 5:00 PM ET

Executives

Richard Galanti - EVP and Chief Financial Officer

Analysts

John Heinbockel - Guggenheim Securities LLC

Simeon Gutman - Morgan Stanley & Co.

Paul Trussell - Deutsche Bank Research

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Kelly Bania - BMO Capital Markets

Sean Carson - Barclays Capital

Matthew Fassler - Goldman Sachs & Co.

Oliver Chen - Cowen and Company, LLC

Daniel Binder - Jefferies & Co.

Robert Ohmes - Bank of America Merrill Lynch

Peter Benedict - Robert W. Baird & Co.

Gregory Melich - Evercore ISI Group

Chuck Cerankosky - Northcoast Research

Operator

Good afternoon. My name is Kimberlynn and I will be your conference operator today. At this time, I would like to welcome everyone to the Costco First Quarter 2017 Earnings Conference Call. 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, CFO, you may begin your conference.

Richard Galanti

Thank you, Kimberlynn. Good afternoon to everyone. Please note that these discussions will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. 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. Forward-looking statements speak only as of the date they are made and we do not undertake to update these statements except as required by law.

For the 12-week fiscal first quarter, that ended two weeks ago Sunday – this past Sunday, earnings came in at $1.24 a share, up 14% or $0.15 a share over last year's reported earrings per share of $1.09. A few items to point out, as was mentioned in today's release, this year's first quarter benefited from a non-recurring $51 million legal settlement. This $51 million pre-tax figure represented a 19 basis point benefit to gross margin and a benefit to first quarter's earnings per share of $0.07 a share.

Last year in the first quarter there were two non-recurring items that we mentioned that together negatively impacted last year's earnings results. In that quarter, we recorded a $22 million pre-tax charge, which represented an 8 basis point impact to SG&A to the negative and a reduction in last year's first quarter earnings of $0.04 a share.

Stock compensation expense was 13% or $25 million higher year-over-year, so $0.04 a share more. There are about 4,800 people of our employees that receive restricted stock units as a significant part of their annual compensation. These grants are made annually each October in our fiscal first quarter, and then typically vest over a five-year period with accelerated vesting when the recipient reaches 25 years, 30 years and 35 years of employment with the Company.

Factors driving this increase included additional levels of accelerated vesting given the rising number of our employees achieving long tenure with the Company. An increased stock price with a five-year ago grant coming off of the thing when the stock price was in the 80's to last year's grant when the stock price was in the 150’s and of course having a larger number of employees in the plan.

Note that the $25 million year-over-year increase in Q1 is a larger year-over-year dollar increase than we'd expect to record in each of the second, third and fourth fiscal quarters of this year, given the October RSU grant cycle. Next, gas profitability, our profits from gas during the quarter as compared to last year's first quarter were lower by about $20 million pre-tax or $0.03 a share, primarily a function of last year's very strong profit results in the first quarter for gas.

Fifth, IT costs. These expenses negatively impacted SG&A in the first quarter on an incremental year-over-year basis by about $18 million or 5 basis points to SG&A, which is about $0.025 a share. And lastly, when I get to the discussion on year-over-year gross margin and SG&A comparisons, I’ll review with you the very positive impact that our new Citi Visa deal has had on margins, SG&A and of course our bottom line.

Turning to the first quarter sales, total reported sales were up 3% and our 12-week reported comparable sales figure on a reported basis came in at 1% year-over-year. Comp sales were negatively impacted by weaker FX relative to the U.S. dollar and slightly impacted by gas price deflation, for a combined negative impact to the reported comp number of about 0.75% of sales.

Excluding gas deflation, the reported 1% U.S. comp figure for Q1 remained at 1%. The reported Canadian comp figure plus 4% would have been plus 5% ex-gas deflation in FX. And the reported 0% other international comp figure excluding gas and FX would have been plus 3%. Total comps reported at 1% for the quarter again excluding gas and FX, would have been plus 2% and of course this plus 2% total Company adjusted figure is also being impacted by increases in deflation and other merchandising categories overall primarily in foods and hardlines.

In terms of new openings, in the first quarter we opened nine new locations which included one relo, so a net increase of eight. And later in the call, I will discuss our upcoming expansion plans for the balance of the fiscal year. This afternoon, I'll also touch on membership trends and renewal rates, again, discuss margins and SG&A in Q1; update on the Citi Visa, the new Citi Visa relationship and the card and which we began offering in the U.S. and Puerto Rico this past June 20th during the fiscal fourth quarter of 2016, talk about e-commerce and then a couple of other items of note.

So going down the income statement, again sales for the first quarter, the 12 weeks ended November 20 were $27.5 billion, up 3% from last year's first quarter of $26.6 billion. And again, on a comp basis reported 1% in ex-gas and FX up 2%, again that up 2% still being impacted by other aspects of deflation that we hadn't called out historically.

For the quarter, the plus 1% reported comp results were a combination of an average transaction decrease of 1.3% on a reported basis and an average shopping frequency increase of 2.2% to the positive. Now the average transaction decrease of 1.3%. This includes again the combined headwinds of FX and gas that I mentioned which is about 0.75%, and I am sure other levels of deflation in other categories. I will give some examples of that later in the call.

In terms of sales comparisons by geographic region, within the U.S., Northwest Texas and Midwest showed the best results. Internationally in local currencies, better performing countries were Mexico, UK and Korea. In terms of merchandise categories for the quarter, in terms of sales for those within food and sundries, overall, flat year-over-year with spirits, sundries and deli coming in best. Tobacco, of course, as I mentioned in the last call was down a little over 20% year-over-year as we continue to see lower sales in that category. As I mentioned before these big tobacco declines should anniversary this coming spring.

For hardlines, also flat year-over-year. The departments with the strong results were hardware, tires, and health and beauty aids. I give you an example of deflation which is impacting this department. And November for example, our reported November sales, TV sales in dollars were up 2% and units were up 17%, so quite a bit of deflation on big ticket items as well as some of the fresh foods items that I mentioned earlier.

Within softlines, up low single-digit comps with apparel, small electrics and special events being the standouts. And within fresh foods, produce and deli were the strongest departments. And in ancillary businesses, hearing aids and optical showed the best results. Again, in recent months we have seen additional deflation overall in the low-to-mid single-digit range in many food and fresh meat categories and a little more in some of the other non-food areas as I mentioned like electronics.

Moving to the line items on the income statement, membership fees good results for the first quarter, coming in up 6% and 6 basis points as a percent of sales, up $37 million year-over-year. In terms of membership fees, good renewal rates, 90% U.S. and Canada actually 90.3% and 88% worldwide, rounding up to 88%. Continued increasing penetration of the executive membership and in terms of number of members at Q1 end, compared to fiscal year end 12 weeks earlier, Gold Star which stood at 36.8 million accounts, at Q1 end it was 37.1 million.

Primary business was 7.3, both at fiscal year end and at Q1 end. Business add-ons 3.5 and 3.5. For total membership, household memberships 47.6

million at fiscal year end and up to 47.9 million at first quarter end and given that many of the people have two cards, many of the accounts have two cards. At fiscal year end, we stood at 86.7 million in cardholders and at first quarter end 87.3 million people with a membership card.

At November 20 first quarter end, Executive Members stood at 17.7 million member households, an increase of 348,000 since the end of the previous quarter. That's about 29,000 additional Executive Members per week increased during the 12-week quarter. And as I have said before, Executive Members are a little over a third of our base and a little bit more than two-thirds of our sales where Executive Members are offered.

In terms of renewal rates, our business renewal rate, which at fiscal year end stood at 94.4%, came in at 94.3% renewal rate as of first quarter end. Gold Star at 89.5% both at fiscal year end and at the first quarter end. For total 90.3% at fiscal year end and it remained at 90.3% at first quarter end. Worldwide, at year end it was 87.6% and it [tick to] [ph] 87.5% at first quarter end.

As you know it's been probably almost two years in Canada when we converted to the MasterCard and with that we saw as we would have expected a slight decline in renewal rate. As occurred in Q4 2016 this past summer, we saw that finally reverse, and saw an uptick in renewal rates in Canada and that continued in Q1 of this fiscal year too. We are now seeing the same thing in the U.S. had ticked down a little bit over the last couple of quarters and have ticked down a little bit as well in Q1. We don't see any issues there at this point.

Regarding membership fees, at the beginning of this past September or beginning of our fiscal year, we increased membership fees in our Asia operations, Taiwan, Korea and Japan as well as in Mexico and the UK. And again, that's because of – due to deferred accounting. It is about 15% of our membership fee income base and due to deferred accounting and the fact that it will roll in over the next 12 months in September that will be a little less than $0.01 a share a quarter.

Before continuing down the income statement line items, a quick update on the Citi Visa card offering. This past June 20, midway through the fourth quarter of fiscal 2016, we stopped accepting AMEX, American Express at all U.S. and Puerto Rico Costcos and at costco.com and began accepting all Visa cards, including of course, the new Citi Visa Anywhere card.

The new card is great in terms of increased cash back rewards for our members and that’s great for us as well in terms of driving member value and sales over the next years, and of course lowering our effective merchant fees related to the new program. In terms of new card, as was mentioned over the last couple of quarters on these calls, there were approximately 11.4 million AMEX, American Express co-branded cards or about 7.5 million accounts that were transferred from American Express to Citi for conversion to the new Citi Visa Anywhere card as over 85% of the accounts transferred over have been activated.

And since the June 20 cutover several months ago, we have 1 million members that have signed up for have been approved for the new Citi Visa card. Most of them have it in hand, but to the extend that it was the last couple of weeks; they may not have gotten their card yet. In terms of conversion, usage and new sign up for the card, all good so far.

Now turning to gross margin. Our reported gross margin in the first quarter was higher year-over-year by 29 basis points coming in at 11.58 this year versus 11.29 last year. As usual, a heavy jot down for the quarter a few numbers will just make the two columns for the quarter, reported and without gas deflation.

In terms of core merchandising, year-over-year in the first quarter, core merchandising was up 19 basis points of 16 without gas deflation. Ancillary businesses down 5%, minus 5 year-over-year and for the quarter minus 6 without deflation, 2% reward, minus 2 in the quarter on a reported basis, minus 1 without gas deflation. LIFO minus 2 and minus 2, other which is the big one-time non-recurring benefit we got from the litigation settlement plus 19 basis points both for the reported and without gas.

All told for the quarter, we reported again the 29 basis point improvement in ex-gas deflation and 26 basis points. So overall, again 26 basis points up on a kind of ex-gas basis. The core merchandise component was higher by 19 basis points year-over-year and again 16 without the gas deflation. The majority of the core gross margin increase and already taking out, we've separated out already the one-time legal settlement. About 13 basis points of that 16 if you will was due to higher year-over-year revenue share and bounties associated with the new Citi Visa agreement.

Some of those monies go to the revenue line as revenue share. The gross margin of our notwithstanding debt, the gross margin of our core merchandising categories, which are the food and sundries, hardlines, softlines and fresh foods. That gross margin as a percent of their own sales were higher year-over-year in the first quarter by 17 basis points with foods and sundries, hardlines and fresh foods all showing higher year-over-year margins and softlines being down a little bit year-over-year and one of the impacts was the warmth of the season and outerwear issues.

Ancillary and other business gross margin was down 5 basis point, 6 basis points, ex-gas deflation in the quarter. All the function of the lower year-over-year gas profits as I discussed earlier in the call, ex-gasoline operations, all other ancillary and other business gross margins were up 6 basis points. 2% reward, again ex-gas, a negative impact of 1 basis point and that's inside margin. That's a sales penetration and the associated executive member awards from our executive members continue to grow.

LIFO in the first quarter flat this year, we did not book a LIFO credit card charge and compared to a 2 basis point positive or a $5 million pre-tax credit last year in the quarter. And lastly, the one-time non-recurring legal settlement has benefited Q1 gross margin by 19 basis points as we discussed in beginning of the call.

Moving on to SG&A, our SG&A percentage in the first quarter year-over-year was higher by 16 basis points on a reported basis and by 13 basis points on ex-gas deflation. Again, I'll have you just jot down a few line items, core operations for the quarter was higher or negative 8 basis points and without gas the negative 6. Central higher by 9 and 9 both reported without gas deflation. Stock compensation expense minus 7 and minus 6. Other plus 8 and plus 8 that’s that rough $20 million or $22 million amount that I told you about earlier in the call that impacted SG&A to the positive last year versus nothing this year.

And again reported SG&A was higher by 16 basis points in the quarter higher by 13 ex-gas deflation. The core operations component of SG&A again in the chart shows 8% higher – I’m sorry 8 basis points higher year-over-year reported and 6 ex-gas. This minus 6 consisted of higher payroll and benefits of about 31 basis points year-over-year that certainly impacted by the lower sales result and certainly that's impacted by the deflation I’ll give you a couple examples of that later.

This was primarily offset by lower year-over-year merchant fees as a result of the switch to Citi Visa. That had a benefit to the SG&A line of plus 25 basis points impact of the positive. Central expense was higher year-over-year in Q1 by 9, increased IT spending again as I mentioned was 5 of that. Stock compensation expense higher by 5 or 6 without gas. And lastly, the other item I mentioned the plus 8 was non-recurring in nature.

Next on the income statement line pre-opening expense was $4 million lower this year versus last year coming in at $22 million versus $26 million a year-ago really a function of openings. This year in Q1 we had 9 openings, last year 13 each of the 9 included 1 relo in the 13 last year in the first quarter and 2 relos, pretty much in line with that number of openings.

All told, operating income in the first quarter came in up $82 million or 11, but up $9 million or 1% year-over-year excluding the - just the non-recurring items that I previously mentioned. Below the operating income line, interest expense in the first quarter came in at $29 million this year versus $33 million in last year. Lower due to the retirement of some senior notes in December of last year.

Interest income and other was lowered by $2 million in the quarter coming at $26 million versus $28 million a year ago. Actual interest income from the quarter was better year-over-year this was offset by approximately $4.5 million in charges related to the FX transactions that usually fluctuate pluses and minuses in the zero to 10 million range, so no surprises there.

Overall, reported pre-tax income on a reported basis was higher by 11% again higher by 1% ex those non-recurring items that I mentioned earlier in the call. In terms of income taxes, our tax rate in the first quarter came in at 34.4 for the quarter compared to 36.1 last year. We benefited from a couple of positive discrete items this year in Q1, our anticipated effective rate for the years expected to be approximately 35.2% as best we can tell at this point. Overall reported net income $545 million this year up $65 million from $480 million last year, so an increase of 14% ex the non-recurring items that I mentioned up 3%.

And next for a quick rundown of other topics, while the balance sheet is included in this afternoon's press release. A couple of the balance sheet info items, depreciation and amortization from the cash flow statement which is not here for the quarter came in at $297 million for the quarter. Accounts Payable if you look at one of things we always look at is our accounts payable as a percent of inventories. On a reported basis it was up from a 100% a year-ago in the quarter and 203%. If you take out 9 merchandise payables and more of an accounts payable of merchandise versus inventories improved from a 90% to 93% from last year's first quarter into this year's first quarter end.

Average inventory per warehouse was actually lower by about $67,000 per warehouse coming in right at $14.9 million a year ago and $14.83 million per location this year. FX was about roughly $70,000 lower, FX was about $170,000 lower just the impact of FX so about 100 net if you assume flat FX. That's about what majors was up electronics, it was up a $117,000, so really not a lot of pluses and minuses over sub-departments but pretty much in line and pretty much flat year-over-year.

In terms of CapEx we spent approximately $670 million during the quarter and our estimate for the whole year as I mentioned hasn't changed from last quarter end, our expectation for fiscal 2017 is somewhere in the $2.6 billion to $2.8 billion range compared to $2.6 billion for all of fiscal 2016.

Next, Costco online, we're now in of course in the U.S., Canada, UK, Mexico and more recently Korea and Taiwan. For the first quarter sales and profits were up, total online sales were up 8% in the quarter and 7% on a comp basis, pretty choppy essentially the first several weeks and the last several weeks of the quarter we're in the mid singles with the middle part of it in the low doubles, if you will.

I want to point out that over the past three weeks and that would include the last week of Q1, which is the Thanksgiving week, and the first two weeks of our second fiscal quarter, e-com sales were up in the low to mid teens including some results for both Black Friday and Cyber Monday. And of course, that's not withstanding significant amount of TV sales which were essentially flat in dollars and up 15% in units.

Lastly, as it relates to our online business, we are improving our offerings and enhancing our member experience. I've touched on this a little bit last quarter's call. Our current focus comes in three primary areas in terms of improving merchandise first, we are adding more exciting high-end brand in merchandise on an everyday basis, we are improving in stocks and high velocity items and there is a few other things that we will be doing coming in the first couple of months of the new calendar year.

Second, we are improving the experience and functionality of our site, we are improving our search that we have and are continuing to do that. We have shortened the checkout process from many clicks to two and so a big improvement recognizing this is new for us. We are simplifying and automating our returns process, a much better experience particularly on big ticket items and we have seen great improvement in that in the last several weeks and we are improving our members' ability to track their orders. Again, that's something that we were terribly good at historically.

And thirdly, we are improving our distribution logistics. We have increased the number of depots from where we fill online orders, so closer and faster and less expensive delivery. And again, look for more improved and quicker distribution comments from us in early calendar 2017.

Next, in terms of expansion, I mentioned we had eight net new units this year, this fiscal first quarter. We plan two for Q2 and net of five for Q3, so ex the relocations. And a net of 16 in Q4 for anticipated number for the year of net new units of 31, 34 less than three relos, so 31 net new locations. Last year, recall we opened 29 so about 4.5% square footage growth. If we get to the 31 that would be about the same, about 4.25% plus square footage growth.

Assuming the 31 net new openings in fiscal 2017 locations by country will be 16 in the U.S. Mind you that last year it was 21 out of 29 in the U.S., eight in Canada which is quite a number for Canada and one each in Taiwan, Korea, Japan, Australia and Mexico as well as France, our first in France and also one in Iceland. Note that these include our first locations to open in France and Iceland and again those will be in late spring and early summer.

Now as you can tell by the quarterly dispersion of these about half of the 31 planned openings are scheduled in Q4. To the extent a couple of those could slip into the next fiscal year, so be it. So somewhere in the very high 20s if not 30 or 31 is what we would expect.

As of first quarter end, our total square footage stood at 104.5 million square feet. In terms of common stock repurchases, for the first quarter, we repurchased 809,000 shares for a total of $122 million on an average price of $151 a share. That compares to all of fiscal 2016, when we repurchased $477 million, 3.2 million shares at an average price of just under $150 a share.

In terms of dividends, our currently quarterly dividend stands at $0.45 a share and that was a 12.5% increase and that was effective last spring. 12.5% increase from the prior $0.40 a share, so $0.45 a share on a quarter, so that yearly $1.80 dividend represents an annual cost to the Company of just under $800 million.

Lastly, before I turn it back for Q&A, our fiscal 2017 second quarter schedule earnings release, date for the 12-week second quarter ending February 12, will be after market close on Thursday, March 2 with the earnings call that afternoon at 2 o'clock Pacific Time.

I will now turn it back to Kimberlynn, and open it up for questions and answers. Thank you.

Question-and-Answer Session

Operator

[Operator Instructions] And your first question comes from the line of John Heinbockel from Guggenheim Securities.

John Heinbockel

So, Richard the new Citi agreement, was that a – was a total benefit in the quarter of 38 basis points if I'm hearing you right and I assume that was exactly what you thought it would be?

Richard Galanti

Probably a little higher than we thought it would be. There's lots of nuances to the program in terms there's bounties that we received for signing up new members and applications that incents the warehouses to do that. There's revenue share on outside spend. I think that's a little more than we had anticipated. We knew and felt that over time it would go up because the exceptions of Visa in terms of the penetration Visa throughout all types of merchants and that happened a little faster than we had anticipated.

There's also some other aspects of it, again, there's lots of little pieces, but those are two of the bigger ones. On the merchant side, on the fee side rather I think some of it's related to the fact that we were making estimates of the different reward - bad - buckets if you will, gas at 4, Costco at 2, those velocity categories at 3. Again there's all kinds of equations there that as that changes there's some sharing and so it's all good at this point.

John Heinbockel

Well, as a sort of the follow-up to that is that recognizing there is some volatility, is roughly that level, is that what you would expect going forward. And right now it's covering right soft sales and some investments in labor would be – is the idea that when that – when the soft sales changes more of that drops to the bottom line or do you think you find other things to invest in?

Richard Galanti

Well, time will tell, won’t it. I think it's still an early program, we're in the first full fiscal quarter of it. Over the next couple of quarters as I said last quarter this will be the first time we'll try to provide a little bit more insight and I'm sure we'll be able to do a little bit more each time. As you know, we're going to invest in loyalty and growth and – while it's raining on everybody as it relates to higher levels of deflation. We're known for deflating the sell price sooner and faster and certainly one other sound bite example would be meat sales, just in the month of November meat sales were up 6% in dollars and 16% in pounds. That's the kind of stuff that this deflation, it's impacting all retailers of course, and it's probably impacting a lower margin quicker to pass it on up or down and certainly down faster, so all those things go into play. So time will tell.

John Heinbockel

And then just lastly, have you found or when you think about this conceptually, is it better to make - more impactful to make price investments when we start the reflationary cycle, right. So not raising while others do as opposed to cutting more now, investing more in a deflationary recycle.

Richard Galanti

Well, we’re always going to do more extreme probably than others. Another example would be as I've said in the past as it relates to some different types of competition out there the competitive pricing moat has gotten wider which is good. We haven't used that to improve our margins consciously in that regard, the wider the better. And so we're constantly figuring out that. We are constantly going back to every supplier with our purchasing power, with our buying power as it relates to – and competition itself with private label to figure out how can we bring the quantity up, the quality up, and the price down.

And we know we will sell more and each of us and our suppliers will make a little more times – a little less more times. And so that's what we do, that's what we're always doing. We see that in every monthly budget meetings. And so I think that we'll continue to do what we do. We're certainly not going to benefit from every extra dollar of income. We're going to figure out how to use it to drive that competitive spirit and to drive our sales. And that's been a little tougher in this tough deflationary environment.

John Heinbockel

Okay. Thank you.

Operator

Your next question comes from the line of Simeon Gutman with Morgan Stanley.

Simeon Gutman

Thanks. Hey guys. So my question relates to core profitability and expectations to the extent we can talk about it. So the EBIT growth this quarter was I think about 4% adjusted, the trend line has been a little lower and I'm not taking a lot of currency into this, but if you think about the core profitability going forward Richard, should we expect it to increase granted this quarter had a tough topline compare, we talked about maybe credit card getting better.

I'm not thinking about membership price increase, but that's something that could come, but is this – just thinking about the overall business, how it’s performing, do you expect it to do better than where it is or performing about where it should be?

Richard Galanti

Well, again I'm not allowed to tell you what I think completely. We're encouraged by the last few weeks including the first two weeks of Q2, but yes we got - we feel good about our merchandising offerings, we feel good about some things we're doing operationally, we certainly feel good about the strength of KS, Kirkland Signature, and traffic has improved a little bit. I remember one of the analysts reports a few months ago, was we can exhale.

We are hopefully beyond that right now. We feel that again the last - the traffic seems to hit a trough and it’s come back a little, not that we expected to get back before it necessarily, but it certainly it's seems like it's back on the mend a little and we'll see. I feel we're doing a lot of good things; we got a lot of things up our sleeve in terms of merchandising, we’re clearly merchandising and selling from a position of competitive strength. And fresh foods drives the business and the fact that renewal rates ex a little bit of impact from auto bill in the conversion are perfectly fine. So there’s lot of good things out there and I guess I'll stop there. But overall we'll see.

Simeon Gutman

Okay. And then my follow-up, part of it relates to what John asked where you know the credit card benefit that could ramp. There also could be a membership pricing straight down the horizon. Thinking about what you’ll reinvest versus what you drop down, I mean are you – is the investment rate being inhibited right now because you haven't had that membership price increase in a long time so or are you going to let some of these things flow to the bottom line when we get there.

Richard Galanti

First, let me go back for a minute to the monies that we've benefited from as it relates to the Citi Visa the new agreement. In theory you would say okay if you made a little more [indiscernible] did you put it back in the pricing. We're doing a lot in pricing anyway and also you don't change the reward structure every day it's a new program.

I would assume over time and this is - who knows if hypothetical but over the next couple of years if the performance of the program continues to go which we expected to do in the right direction and our piece of that action if you will versus the rewards that our members are getting, you’d expect to see this change that over time. But we're way too early to even think about that.

Historically, as it relates to membership increases, we usually invest that back in the business, a lot of that in terms of competitiveness and pricing and it kind of eases in over the next several years and more fully into the bottom line notwithstanding in fact that membership fee increases take about eight fiscal quarters to get into the income statement on the membership line because of deferred accounting.

So I don't think first of all we certainly haven't done anything different. As we've seen in some examples where we do comp shops versus certain others, where that moat has gotten bigger if you will, that gap has gotten wider, we haven't said hey let's use this to get a few extra basis points of margin. We've held the course and we continued to go in that direction.

Simeon Gutman

Okay. Thanks.

Operator

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

Paul Trussell

Hey, good afternoon Richard. Just want to touch back on margins with - we think about the core GPM, X the benefit from the Visa card. It was still up but maybe a little bit less than the past few quarters. If you can maybe just touch on that and then also on the SG&A, you mentioned the higher payroll and benefits but if I recall I think the second quarter last year is when you raise some wages. Is that correct and should we start to cycle some of that headwind?

Richard Galanti

On the last point, the wages, I believe the U.S. and Canada which is 80 plus percent or 80% to 83% of our company. We took the bottom of the scale up a $50 basically from 11.50 in 12 up to 13 and 13.50. I believe on an annual basis that's about a $40 million incremental increase in our pre-tax costs or about $3 million little low $3 million per month number. That started in March, so that's kind of halfway through - early the halfway through Q2 of our fiscal year that's when the annual anniversaries and that's kind of a small. I'm sorry, the first part of the question, I didn't write it down.

Paul Trussell

Just around core merchandise margins.

Richard Galanti

Yes. Keep in mind, as I try to point out on each of these calls and mentioned what was the core, roughly 80% plus of our business that is food and sundries, hardlines, softlines and fresh foods. What is that margin on its own sales? And again, as I mentioned earlier in the call, that was up 17 basis points. When I look at the weighted average of what impact it had on our Company margin year-over-year. It's a lot less than 17 because there's increased penetration of another category with a lower margin or reduced penetration of another category with a higher margin and so that tends to – that's what we pointed out. We don't see just because that that 80% was 17 basis points up on that that had a much smaller effect on the year-over-year for all company.

Paul Trussell

Got it. And then just when it comes to topline, Richard, obviously November was kind of a tell of two periods with the first half of the month and the second half being much better and from the comments you made around e-commerce, it sounds like there's been some strength maybe that sustained into early part of December. Just kind of what's your view right now kind of the spending levels of your core customer and as we turn the corner into 2017, what's your thoughts around kind of what our core comp expectations should be particularly in the U.S.?

Richard Galanti

Well, again, we don't know. We’ll have to wait and see ourselves. We are thrilled that the first few weeks have been good. And again, November, the four weeks of November was choppy frankly, particularly the week of the election. I think it was worse than a snowstorm in terms of nobody wanting to go out and buy stuff and that’s what I read about other retailers as well.

And again, over the last few months it's been a little choppy a little more in November and a little weaker and so at least, what we can tell you at this point is the first couple of weeks have been okay. And again, traffic has seemed to have stabilized until something changes there, who knows. But again, we feel good about our merchandising what's going on and one of the reasons we continue to provide monthly sales results is for that reason to keep you guys informed and that's pretty much what I can tell you at this point.

Paul Trussell

Fair enough. Thanks Richard.

Operator

Your next question comes from the line of Michael Lasser with UBS.

Michael Lasser

Good evening. Thanks a lot for taking my question. Richard, you mentioned that you signed up a million new members under the new Visa credit card arrangement. Is that above and beyond what you would normally sign up? Or is that typical with your run rate and how does that compare to your expectations?

Richard Galanti

First of all, we signed – million of our members signed up for it. Many of them could very well be existing members that historically did not have an AMEX card or historically used not a co-branded AMEX card. And they have now signed up for this because they want to sign up because the rewards, hopefully or they historically again were using debit or non co-branded AMEX card and are now switching to this. So it's not that we did not generate a million new members.

Certainly, when a new member being online or walks in and to sign up as a new member, we of course are telling them the virtues of both executive membership and these great new co-brand card.

Michael Lasser

And how are you seeing the spending patterns of those who signed up for the card or got the card versus how they're spending patterns were under the AMEX card?

Richard Galanti

It's hard to know this quickly. Generally speaking, irrespective of what credit card it is whether it's a co-branded or rewards card for an airline or hotel. Generally, we find the people on credit card spend more than by cash or check or debit. We also find the people with Executive Member spend more than non-Executive Member.

So the trifecta if you will is when they are not only a member, but they're the Executive Member and they use the co-branded card. Lots of incentives for loyalty and for spend and for capacity of the spend. And so that's what we try to do, try to do it in not too hard of a seller as you might expect.

And we've got a lot better doing the basics with it. We know existing members, by a lot historically based on their prior 12 months and it’s a no-brainer to be an executive member, we make sure they know and we've done a better job of converting or getting people signed up as an executive member start with.

The credit fee, of course is not completely in our hands whether it was the 16-year relationship – 40-year relationship, 40-year or 60-year relationship with American Express or the new relationship here is up to the credit card issuer in this case Citi to accept or rejected application.

Now, the ones it converted over they were all in the same deal, but anybody knew they are signing up for new card and there's going to be some people they get and some people don't. But when we do know is a million of the people that did sign up for have gotten it or approved and got it.

Michael Lasser

My follow-up question is on the prospects for import tariffs, what percentage of your goods do you import from overseas and if you could break that down between the Kirkland's brand and all other it would be very helpful?

Richard Galanti

We're just asking or being asked that question recently and we're putting some members together. Our best guess is somewhere north of 20 and south of 30 and I give you a purposely large number because even you talk to some buyers in different apartments, you find out that it might be imported, but it's all based on this U.S. dollar sale and my guess would be somewhere in the mid-20s.

Michael Lasser

Mid-20's as percentage of your total sales?

Richard Galanti

Yes.

Michael Lasser

Okay. Thank you so much and have a good night.

Richard Galanti

In the U.S., now I'm assuming that includes – I'm including in that like electronics. Most electronics are purchased in U.S. dollars by U.S. trading companies that are arms of the overseas manufacture. And so again it's a little tenuous to come up with an exact number particularly since we just started looking at it.

Michael Lasser

Okay. Thank you very much.

Operator

Your next question comes from the line of Kelly Bania with BMO Capital.

Kelly Bania

Hi, good evening. Thanks for taking my question. Wanted to ask a different question about gross margin, it's still if you look at the core gross margin I think you set up 17 basis points still very strong, but I think it's been in the 10 basis point to 15 basis point range. I know you've talked about online, organics some of the higher margin categories in the mix shift there, is just curious if those are really still some of the same drivers or if there's anything else going on there particularly as online seem to slow a little bit this quarter?

Richard Galanti

I think part of it is as prices have deflated there are instances where we could make a little more, but not a lot more where others have not deflated them as much even though we're going to be the first to take it down and more there's still a little there on the table. Private label helps. I think those are the kinds of things and we've also in terms of driving business, working with our vendors to lower the price and drive more business. And we will participate in it, but we'll still make a little more.

So there's lots of little reasons and again I'd be remiss to say, I mean year-over-year, we had just under a basis point and shrink recovery, in other words better shrink number, inventory shrinkage numbers. We don't talk about it because I mean good news is continues to improve a little for 30 years essentially. We were doing a better job of operating our businesses and controlling our inventories, but it's lots of little things.

Kelly Bania

That's helpful. And then just another big picture question, lots of questions on the savings and how you would think about possibly maybe reinvesting some of that over the years, but as I hear you online and proving that experience to check out experience to search, do you look at ways to just make things more convenient for your members? Is there anything else you think about on the convenience front versus just the price front?

Richard Galanti

I got to tell you, a little tongue-in-cheek here, but we arguably were little – have been – many years ago we like it to even do e-commerce, did a little bit begrudgingly, it took a while to do some more things. I think the things that we're doing offensively not defensively, but we're also probably a little stubborn along the way to suggest – there are some extreme examples of when a member orders a big ticket item electronics or light goods or whatever and the delivery window is much larger than anyone else's.

They'd like to know it pops up the calendar and here it goes. When they want to return it that process was not very good. And some of these are quick fixes, search was not very good. That's been a quick fix to get a significant improvement and we get some more improvement.

So I think that we're doing some things to that we've notwithstanding decent sales. We're investing in better [indiscernible], but by the way that's not at the expense of we want to take our prices down a little and those are truly independent whether it's IT modernization efforts some of which was in necessarily or you know what are we going to do with regard to we need another 10 million or 50 million or whatever to enhance the site, that is truly independent of what we're doing there.

We know as Jim said it will set for 25 plus years and [indiscernible] is set for now five plus years. We are clearly a topline Company and we're best when we drive sales. We probably aren't as good at leveraging expenses when sales come down than others because we’re not going to do some things, but we're clearly taking the offense. Again there is some things that perhaps we should've done earlier but we're already seeing some improvement in that we know that will help.

Kelly Bania

Thank you.

Operator

Your next question comes from the line of Karen Short with Barclays.

Sean Carson

Hi, Richard, this is Sean Carson for Karen. Thanks for taking our questions. Can you talk about your outlook for deflation and any signs of leveling off or maybe even an upswing?

Richard Galanti

I'm sorry, I couldn’t hear the question.

Sean Carson

Sure. Sorry about that. Can you talk about your outlook for deflation and any signs for potentially leveling off or potentially an upswing?

Richard Galanti

When we talk with different category buyers probably the ones that have more specific insider on the fresh foods size because they're dealing with commodities and negotiating they're actually looking at the futures contracts and more of the cost is the actual item, the orange or the poultry or the pork or whatever.

Whereas sometimes that's not the case, I think usually when we ask there's another three months to six months whatever. And when it gets to the anniversarying of it, there’s been some huge swings, some huge example of swings on some nuts which last year doubled and we’re now down 35%. There's you know eggs of course are down well over 60% year-over-year.

So if eggs were down even 50% it doesn't mean that people going to eat twice as many eggs to have flat sales. They're going to eat some more eggs, but not that many. So by the way a few of those things may help in the bakery, the margins of the bakery. We’re going to - also not going to change the package the cost of 16 muffins or 15 muffins.

So overall, I think the feeling has given that the last few months have been a little more deflationary. The view is that it's another few months of that, but they all believe that it's going to come back the other way and this is a lot of estimated semi-educated guesses among different departments.

Sean Carson

And so I noticed there's also no LIFO reserve, apparently there is no charge or credit in the quarter. Is that right?

Richard Galanti

Right. That's correct.

Sean Carson

Okay. Thanks for that.

Richard Galanti

By the way as effective the beginning of this fiscal year for 30 years we've been on our retail cost systems, retail inventory system. Most companies historically have been on a cost base system where you can get down more granularly to item level with the modernization that was part of this process too. With a cost system the way you value inventories will not have LIFO charges and credits in the future.

Unidentified Company Representative

[Inaudible]

Richard Galanti

At the beginning of the year you'll notice on our year-end balance sheet. We revalued the inventory at cost in a different way and it was about a $60 million plus reduction in inventory. At the beginning of the year but not a P&L impact.

Sean Carson

Got it. Okay.

Richard Galanti

To the extent there's inflation in the future, we will have a LIFO charge. I'm giving myself a thumb up. And once you have some LIFO charges, you can have credits. To the extent that there was LIFO as deflation right out of the box. You won't take that credit because you have no charge against to which you can take it.

Sean Carson

Got it. All right. That explains it. Thanks for that. And just my follow-up is just an extra week this year. Can you give us a sense of the impact? I think my math was about $0.10 to $0.11, but curious if you think that’s sort of the right vicinity.

Richard Galanti

Well, it sounds like that's 2% of X. I don't have a calculator in front of me, [150 third] of a year. For the most part, most expenses even though say on a rental facility, you pay 12 monthly rents; we take it over the 53 weeks. I mean you don’t get a [150 third] credit for that. We amortize it over the course of the 10 years or 20 years. And so there's not a lot of – it generally should be if it's 2% more weeks, it’s 2% more earnings.

Sean Carson

Thank you.

Operator

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

Matthew Fassler

Thanks a lot. Good afternoon, Richard. My first question relates to the Citibank Visa deal. Can you tell what impact the enhanced cashback features have led to? Has it been in your view more sign ups, has Citi seen more traction with some of the categories where you increase the incentives for consumers?

Richard Galanti

Well, I can't speak for Citi. To you I can't speak to them. But we certainly have discussion with them, but they've made their own comments that I think we are generally positive about how the program is working so far for them. What I can tell you from our perspective is some of things I already mentioned in terms of – look it's a significant improvement in the value proposition of the reward to the members assuming they spend like they did.

Hopefully, they'll spend more because of the 2% at Costco instead of 1% on top of executive rewards, the 4% on gas instead of 3% and 3% on velocity categories instead of 2%, so all that stuff is good. There's more utilization, there's more places to use the card. Typically these are smaller merchants that only perhaps accept certain brands over others, they pay higher fees, but we'll have to see.

Matthew Fassler

Are there any surveys you've conducted that would suggest customers have really digested that extra penny they're going to get back at the end of the year?

Richard Galanti

No.

Matthew Fassler

Okay.

Richard Galanti

What I can tell you from talking to our Head of Membership marketing is it stands out in good print on everybody's monthly statement, they see it and it's pretty big pretty, pretty fast. And so I think those are the types of things that people look at. We know if any programs work. And again, based on Citi's comments, publicly it seems like it's working in the right direction for everyone which means more spend on it.

Matthew Fassler

Great. And then my follow-up is on deflation and gross margin, we've looked through your transcripts going back quite a while and this is a period I think a remarkable deflation particularly in the context of a decent U.S. economy. In your experience, how those gross margin progress through a deflationary cycle? You talked about your expectations for when if and when deflation turns and number of months going forward et cetera. But in the past as you've seen food prices in particular recover, how do your gross margins tend to behave?

Richard Galanti

Really is all over the board. I mean with inflation the dollars go up, the percent probably changes a little downwards, so that would imply perhaps a little bit of improvement in dollars, but it could be all over the board. Gas is an extreme example; it is a low margin competitive business. As prices tumbled dramatically across general competition, prices were lower, but not nearly proportional to the amount of savings to that retailer.

We were able to improve our margins little and widen the gap that's a win-win. Another silly example is organics. Organics because there's perhaps a little bit of less price sensitive – elasticity to organic prices. We are able to make a little more margin not a lot and have a wider value proposition versus others, so those are good things for us.

Generally speaking, when there was cost inflation on milk and cheese and things like that, we would point out as you know historically some of those quarters were we kept the chicken at 499 and margins went down essentially from something to nothing to the tune of $40 million a year on one item that was four, five years ago – four years ago.

Conversely, when cheese prices fell, food court margins went up nicely because we've always – we never really change the price of a slice of pizza. So there's lots of little things that don't fit in a square box or – a square box or round hole here. I would say generally a little inflation is good, it help sales and we could be more competitive both up and down. And when price is going up, probably is a little bit more margin beneficial.

Matthew Fassler

Thank you so much. I appreciate it. Thanks Richard.

Operator

Your next question comes from the line of Oliver Chen with Cowen and Company.

Oliver Chen

Hi, Richard. Thanks. What are your thoughts regarding bricks plus clicks and whether that would be by online pick up in store, reserve in store, car pick up from store because we're just seeing a lot of innovation as retailers in pure plays go into physical retail that are previously digital, so I want to know what's you think about that and if it's meaningful for you and if we should be concerned about your long-term store traffic trends with the rise in Amazon. And then mobile is about two-thirds of online traffic from many retailers, what should we expect for your mobile app in the five-year plan for what you want to do there to make it really exciting and fun and great?

Richard Galanti

Well first, we're fixing some of the basics and improving some of the basics and I'm pretty excited about some of those things. You mentioned a number of mobile versus non-mobile e-commerce sales. Our numbers are lower than that mobile, but they're improving quickly. Again, we've recognized those things that we can and can't do. We think that we could and should do a lot more online, but we also as you pointed out want to get people into the warehouses.

We think that some of the things that we do in store will keep them coming. So far it's not been an issue and even – while we try to point out these things each quarter in terms of traffic, in terms of even when traffic was impact a little bit, we're asked that $64,000 question is it all these other things. We see some of the categories that one would think would have been impacted negatively by it aren't being impacted negatively.

In terms of click and pick up, we've looked at it and we are not prepared to do that at this point. When we see it in other places not just the other warehouse club, you need space for it or you need a lot less volume in the location for it neither of which we have and we're not getting a lot of demands for it.

We do that at business centers. You can log on and get it delivered and so that's more for the business member not the individual. And we recognize that we're not the retailer, they're going to sell you a smaller pack size or something and even a little bit higher margin. That's not what we do. Now time will tell over time, there's a lot of things that are going on out there.

We're looking at them. We've all seen the video from earlier this week about you just walk in.

There's a lot of other brick and mortars that my guess would be far more impacted than us on that, but we'll have to wait and see. Again, we're going to – if renewal rates trends changed – by the way we’ve been seeing the markets where we've done things with Google and where we work with Instacart as well. Google Express and Instacart are probably the most extreme example would be the bay area where we started with Google and that was their first market and certainly that's where they're headquartered.

And it's doing fine what we found is an existing loyal member is coming in a few less times a year and shopping several more times plus certainly several more because it was zero. We are shopping more, but some of the two is more. They buy a lot less when they are doing it online when they come in and part of that is the experience of [walking in and seasonal there] even if not everything is offered, but [indiscernible]. So the good news is [Technical Difficulty].

Operator

You’re live Mr. Galanti.

Richard Galanti

Thank you. Hi, Oliver, yes.

Oliver Chen

Thanks for answering that. I just wanted to briefly ask you, does scan and go make sense for you or is that something that's not conducive to your experience. And then as you do your own research on Amazon which categories or what would you say like try out your best competitive advantages and what are your opportunities just to make sure you remain very competitive against Amazon and how are you feeling about millennials and generation Z. It sounded like you still had a lot of good momentum with younger demographics?

Richard Galanti

Well, look in terms of scan and go honestly we did a version of scan go literally 20 years ago a customer I remember walk in get an RF gun, radio frequency device walk around scan their own items come up to the front hand that thing to the cashier and the scanner and they print out a receipt. Needless to say, there's a lot more efficient things today. We continue to look at scan and go type things, we are not testing it currently but we are looking at it.

And I'm not suggesting we are going to do it. We have done self checkout for a while. We've chosen to not do self checkout and higher volume units because we get people through without it. And as it relates – in terms of millennials and generation Z all those numbers are doing better for us and part of it is things like not that we set down and strategic - how do we get them. We have a great value proposition certainly some of the things that we sell like organics in my view is a big impact to that.

Certainly some of the things we do you know we've done a couple of tests with LivingSocial over the last couple of years. All those things, we think help. As it relates you asked question about Amazon and Amazon is also the word for everything out there that's delivered or dot com and everything else it's certainly they're doing a lot of things. We want to make sure we understand what all of these people are doing. We do not just from a competitive price shop and whether it's them or someone else.

We recognize convenience is a value but there's also some things that we can and can't do. So I think that we're looking at these things offensively not defensively at this point. I don't think that I think we're encouraged when we see the level of millennials if you will that are signing up and we see the average age of our membership coming down. Now you know it was just a couple years ago when the average U.S. Costco adult member was four plus years older than the population as a whole now it's a little under two.

And that's without a lot of planning but it's what we do and I think part of that's the merchandise selection and our ability to change merchandise pretty quickly and certainly things like again organic standout in a big way. I think the fact of what we're doing even on some things that aren't directly; they're all related to the business but ESG and sustainability how we take care of our employees, the culture.

Those are things that, again, we didn't say we have to do better at that. We do best at that, we do a lot of good things like that. When it comes down to merchandising, we believe that organics, the KS, what we're very good at is driving value and we're probably not going to be the person that's the best of delivering smaller size goods to your house. There are some things we're going to do between that and nothing and again stay tuned for calendar 2017.

Oliver Chen

Thanks. Happy holidays. Best Regards.

Richard Galanti

Thank you.

Operator

And your next question comes from Dan Binder with Jefferies.

Daniel Binder

Yes, hi. Good afternoon. My question was around some of the things you've already covered including pricing and the moat that you said is opened up. And in light of that there's been a lot of debate around the traffic just north of 2% or just under 3% depending on the months and lot of questions around convenience.

And I just wonder as you review this online strategy, do you think there needs to be a major shift towards a broader SKU assortment, obviously Amazon's got marketplace, Wal-Mart is building marketplace, targets chosen not to. Do you think as part of that convenience factor Costco just needs to materially up their SKU count online?

Richard Galanti

Well, keep in mind we have materially upped it over the last couple of years. Recognizing it's still a fraction of anything else out there. If we were again at 3,700 active items in a physical location and roughly that many online excluding like office products which is through a third-party and there's several thousand of those items, but in terms of what we do ourselves and we now taken it up to 8-ish, 8,000 maybe a little more.

Is it likely to go to 40,000 or 50,000? Absolutely not. Unless it does one-day, but I don't think so. And is it like you go up a little bit more? Sure. And is it likely for us to do a few more things that provide convenience? Yes, but we still want you in the door. And again to Amazon and others credit, they’re trying a lot of things. Some will work and some won't and we're pretty good at understanding what works and figure out how to augment and to do what we know how to do and what we want to do. And we recognized that we can't be – sell you a smaller size or something and our margins nor we prepared to double or triple the margin to do so.

Daniel Binder

Got it. My other question was around the membership fee or potential membership fee increase, next year that's been talked about quite a bit. I'm just curious if there's a sensitivity and what that threshold is, at which point you would not do it. In other words, if the comp store sales were to continue being at the level that they were at in the first quarter, would you be less likely to put it increase through and maybe an easier way to talk about it is what kind of comp level would you like to be at when you do it?

Richard Galanti

Directionally, I responded in the past by saying if comps were a little weaker, it would be more likely to want to do it or no impact on that decision. It's all in our view about what additional values that we brought to the table. Whatever amount of an increase might be contemplated, have we improved the value proposition significantly greater in that amount which is in my view is always been a no-brainer for us. Our renewal rate is okay and if sales are a little weak, it would be the time to do it – not do it. I'm not trying to suggest that it’s tomorrow afternoon, I'm just saying that generally speaking a little bit weaker we're going to use that to drive business.

Daniel Binder

Okay. I guess my question, my response to that is, if you had this widening mode in place and you are priced right. This idea that you would reinvest membership fee dollars into price, do you think that would drive an incremental gain to get comps at a higher level?

Richard Galanti

On some items, yes, on some of things that we do. If you keep in mind, 30 years ago, the original business for 33 years ago, the original business plan and talked about it. It doesn't matter where you locate. You could be on the other side of the railroad tracks and in downtrodden area people come to you, it’s a destination.

And that was fine until you add into that sentence until somebody is between you and your customer. And over time while we’re certainly not at the mall, we recognized that we have to do something. So what we're doing online right now with some of the member experience and distributions, timing and costs and capabilities. Those are the types of things that we are investing in.

Vertical integration and some aspects whether it's the chicken plant or bakery commissary in Canada. There's a lot of things that we're doing to drive value not just lower the price, but I don't – yes, I don't see it that being a reason to do it or not to do it. We look at it as a – it's a value proposition. We may become a little – price is primary and I think it will continue to be primary if we look at a few other things as well.

Daniel Binder

Great. Thank you.

Operator

And your next question comes from Robby Ohmes with Bank of America.

Robert Ohmes

Thanks. Hey, Richard. Hey, you mentioned going into Iceland and France and I know you guys are doing Kirkland on Tmall in China. Can you just maybe sketch us up on when you might ponder opening brick and mortar up in the Mainland China? Thanks.

Richard Galanti

Sure. Well, on Tmall I think it’s about 300 items about a little over half of which are Kirkland Signature, so it’s certainly the cast name is getting known and that's a positive. We've continued to look at it for a number of years. Is it in the next couple of three years? It's probably more likely to say yes to that than two years ago or five years ago, but there's nothing definite at this point.

Robert Ohmes

Okay. And just a quick follow-up on the credit card. Is there any – the new sign ups for the card, anything on the demographic side of who is signing up that's different than what you were seeing with AMEX card?

Richard Galanti

No. Not at all. I mean, they are called millennials instead of something else now, but that’s no.

Robert Ohmes

Got it. All right. Thanks very much.

Operator

Your next question comes from Peter Benedict with Baird.

Peter Benedict

Thanks. Couple of quick ones. First, just on the Google Express, can you just talk about are there any plans to expand that. I know you mentioned the Bay area, but we’re hoping that being done or any thoughts to moving that out?

Richard Galanti

Start of the Bay area, but then with LA area and in the last couple years is expanded to as well Chicago, Boston, New York and D.C. I believe they're expanding and we're expanding is a few other markets as well. I believe I don't have that list in front of me, but I know it includes a few more. So let's say it's going from 6-ish to 12-ish plus and now recognizing we're working with them in different markets, testing different things. I think we've done a couple of small tests with some fresh foods, but it's a limited selection of items and each of these are little different.

Peter Benedict

Sure. I understood. On tobacco is that – is the weakness in tobacco - does that have any kind of a material effect on a core gross margin, I understand that’s a very low margin for that product?

Richard Galanti

Well, it's a low margin business so it would help improve the margin a little bit.

Peter Benedict

I mean is that a material benefit to your core margins right now or is it…

Richard Galanti

No. Gas would be an offset to that in a bigger way in my view.

Peter Benedict

Okay. And then last just on capital allocation. Remind us kind of what your thoughts there in terms of priorities in a way that you on leverage – some of your leverage ratios to get down for the next year so what your thought there? Thank you.

Richard Galanti

Well, first and far most CapEx is expansion and expansion is not – first and far most new units or the improvements in existing units a little bit, but probably an equal priority is all the things associated with it ancillary businesses, whether it's gas stations or as well as some of the manufacturing things we're doing. We're opening up a second – we've had it for a number of years a B plan in Tracy, California.

That does I think around 200 million pounds a year 4 plus million pounds a week of four or five items that are us. It's our items. We're opening B plan on the east coast shortly. In Canada, we're building. I think we've broken ground on a commissary for bakery. We are investing 250 million plus and closer to 300 million on a big chicken plant, processing plant in Nebraska. That is not broken ground yet, but it's in the process of getting permits and stuff.

And so there's things like that as well. We're still spending money in IT, but priority-wise none of this stuff impacts what we're doing for expansion.

We're expanding as much as we want you know we try to be - we look at our dividend every year you know historically it's been about 13% plus increase year-over-year for the last nine years or 10 years since its inception in 2005.

We buyback a little stock, in terms of leverage you know arguably some would say that we are - I would say we're well capitalized, I would say we're under levered. We've got $1.1 billion 10-year fixed rate debt instrument that comes due in March 2017. The good news is that, it’s got that low, low fixed rate of about I don't have it in front of me - about 5.5%. What we do in terms of whether writing a check for it or refinancing part of it, we’ll see. So no big changes of what we do. We’ve done a couple of special dividends, one in late 2012 and one in early 2015 and I'm not indicating if we are – we are into the future that was something that we chose to do it at that time.

Peter Benedict

Okay. Fair enough. Thank you.

Operator

Your next question comes from Greg Melich with Evercore ISI.

Gregory Melich

Three quick ones. Of the 15% of people that haven't activated the card, what are those people using? Are they using other Visa in their wallet? What can you tell us about their behavior? Are they coming less frequently or using cash or what are they doing?

Richard Galanti

Well a bunch of them it's between 11% and 15%. But a bunch of them is, are people that it was not active as a co-brand AMEX card. We had about 15% that had not – upon conversion about 15% of the 11% or whatever million people in the 7.5 million or so accounts about - just under 15% of them had not been using the prior two months I believe, the prior 60 days.

And not to suggest that may be some of them just hadn’t used it and they will use it or they’ve been out of town or whatever else.

It's every answer on this - and I think the vast majority of would be that, though, they were using something else in their wallet. And to the extent that the membership card was on the back, they still have it in their wallet and they still have to do it in their wallet and hopefully they see those giant signs and they reminded the cash register by the cashier and have you heard about the 4321 or the new exciting warranty program on electronic, on TVs where you get a four-year free warranty if you use it at Costco.

Gregory Melich

All right. Any other ads you want to put out there, or we will leave it at that?

Richard Galanti

I thought I would do that just I didn't have it in my script.

Gregory Melich

That’s great. So then the second question is on international, so that's an area that as traffic has been running below the U.S. now for a while which has been kind of unusual to look over the last few years. Could you give us some insight as to why that is and how that's behaving maybe in the markets where you raised the fee, is it linked to that? Or renewal rates doing okay in those markets where the fee went up?

Richard Galanti

It's mostly cannibalization. We've got a $200 million, $300 million business. You open up a second one in that Citi. The new one does 100 to 100 in a quarter or 100 to 150 and 75 of its bled. Let’s say your traffic number is the old unit that's being cannibalized, so on the basis of 10 or 12 units that’s the biggest single reason.

Gregory Melich

And on the markets where the fee went up.

Richard Galanti

There is probably a little bit of softness in Japan beyond that. And I can't say you why and other than – the economy has been tough there, but it rains on everybody.

Gregory Melich

And in terms of the markets where the fee went up, what have renewal rates done in those markets?

Richard Galanti

I am sorry.

Gregory Melich

What have renewal rates done in the markets where the fee was increased?

Richard Galanti

Well, it just happened three months ago. We don't have any numbers yet, but it's de minimis of anything. And that's why I actually asked our marketing people earlier today [indiscernible]. Bob has made a good point. It takes about six months to know because you've got people not every member comes in every two weeks. So trend wise we don't see any big issue there at all.

Gregory Melich

Fair enough. Good luck.

Richard Galanti

Thank you, Grey. Why don’t we take two more questions?

Operator

Your next question comes from Chuck Cerankosky with Northcoast Research.

Chuck Cerankosky

Hello Richard. Just a quick question about what you're seeing in Visa usage from people who are using – who never were AMEX card, Costco AMEX cardholders and how they're spending behavior is changed or somehow affected by Costco accepting Visa's payment now?

Richard Galanti

It's up. Particularly somebody – to the extent somebody is choosing to use another Visa card in his or her wallet. Maybe it’s airline program or hotel program. They may not be spending more because nothing is changed in their wallet. To the extent that they are using cash or debit that's you see an increase and we have seen that as we would have expected.

Chuck Cerankosky

Are you seeing any related impact on membership? Are you able to see if new members are being generated by the Visa acceptance?

Richard Galanti

Well, we know that's the case to a small extent though, Citi for example is done marketing activities in their branches, but it's more existing members that it converted and you'll get a few – few could be in the tens of thousands, but out of a million couple or 20,000, 30,000, 40,000 is not a big piece of that.

Chuck Cerankosky

All right. Thank you.

End of Q&A

Operator

And we have no further questions.

Richard Galanti

Okay. Well, thank you everyone. Have a good afternoon.

Operator

This concludes today’s conference call. You may now disconnect.