Costco Wholesale Corporation (NASDAQ:COST) Q4 2014 Results Earnings Conference Call October 8, 2014 11:00 AM ET

Executives

Richard Galanti - Chief Financial Officer

Analysts

John Heinbockel - Guggenheim Securities

Peter Benedict - Robert Baird

Mike Otway - Wolfe Research

Meredith Adler - Barclays

Joshua Siber - Morgan Stanley

David Schick - Stifel

Greg Melich - ISI Group

Mathew Fassler - Goldman Sachs

Charles Grom - Sterne Agee

Charlene Wong - Credit Suisse

Bob Drbul - Nomura Securities

Operator

Good morning. My name is Brandy, and I will be your conference operator today. At this time, I would like to welcome everyone to the Costco Fourth Quarter Earnings Conference Call and Year End 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, sir.

Richard Galanti

Thank you, Brandy. Good morning to everyone. This morning we reported our 16-week fourth quarter and 52-week fiscal year 2014 operating results, both which ended on August 31. These results are compared to the similar 16-week and 52-week periods in the prior fiscal year ’13, which ended last year on September 1. In addition, we are reporting this morning our September sales results for the five weeks ended this past Sunday, October 5.

I will 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 these statements involve risks and uncertainties that may cause actual events, results and/or performance to differ materially from those indicated by such statements.

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

To begin with, our fourth quarter earnings results, for the 16-week fourth quarter, earnings came in at $1.58 a share, up $0.18 or up 13% from last year’s fourth quarter earnings of $1.40.

In terms of sales for the fourth quarter, total sales were up 9%, comp sales were up 6% on a reported basis, and excluding gas and FX impacts were up 7%. For the quarter, gas prices year-over-year were essentially flat, so no impact on the 6% U.S. comp figure.

However, foreign currencies overall weakened relative to the U.S. dollar year-over-year in the fourth quarter with biggest impact in Canada. Such that our reported 6% international comp figure assuming flat year-over-year FX rates would have been up 8%.

In terms of sales for the five-week September period, total sales increased 7% year-over-year and reported comp sales increased 4%, and again excluding both gas and FX impacts comp sales would have been up 6%.

In terms of comparing our $1.58 earnings figure for the fourth quarter this fiscal year to last year's fourth quarter of $1.40, there are five items I'd like to point out. First, FX, in the fourth quarter year-over-year currencies in the foreign countries where we operate on an overall basis weakened versus the U.S. dollar, resulting in our reported foreign earnings in Q4, when converted into U.S. dollars being lower by about $14 million pretax or $0.02 a share than these earnings would have been had FX exchange rates been flat year-over-year.

Second point, LIFO, last year in the quarter we recorded an $8 million pretax LIFO credit or picked up of little over $0.01 a share. This year in the fourth quarter we have LIFO charge of almost $11 million or about $0.02 a share charge.

Third point, income taxes, our income taxes this year in Q4 included several discrete items that in the aggregate increased our income tax line by about $8 million. The $8 million of additional taxes included a few positive items that benefited or lowered our taxes by about $7 million in total.

However, these positive items in total were more than offset by a $15 million income tax charge related to our decisions to repatriate from Canada back to United States about US$1.2 billion or CAD$1.3 million or Canadian cash -- operations cash balances in the near future. In all, the $8 million net income tax increase from these discrete items, a negative impact to earnings of about $0.02 a share.

Fourth item, our company bonus accrual, I discussed in last year's earnings call that our fourth quarter 2013 quarter results benefited by reversing or bringing back a portion of the company's bonus accrual, as our fiscal '13 results caused us to pay bonuses at a lower level than we had accrued throughout the year.

This year in the fourth quarter our accrual for the year end bonuses was not reduced in the fourth quarter as it was -- as it had been last year. Overall, this represented a $0.04 a share negative swing year-over-year to our bottom line. Remind you that the bonus program impacts a little more than 4,000 people who participated in throughout the company.

And last item I will point out is gas profits, this year our gas profits in Q4 were quite strong representing an additional $0.05 a share to earnings year-over-year. Overall, $1.58 earnings figure for the years fourth quarter was reached by several discrete items representing $0.05 or $0.06 a share in the aggregate that did not go our way.

Now to the subject to new openings, for all of fiscal ‘14 we opened 30 new locations, 17 new in the U.S., three each in Canada and Australia, two each in Japan and Korea, and one each in the U.K., Mexico and Spain, that being our first unit opening in Spain.

We ended fiscal ‘14 with 663 locations operating worldwide. For the current fiscal year fiscal ’15, our plans are to open 31 new warehouses and also relocate four existing locations, 19 of the planned 31 new locations will be in the United States, with remaining in international markets.

Inevitably, up to a few of these will get delayed. So I’d estimate that the number of new units in fiscal ‘15 will most likely be either in a very high 20s or up to 30, plus the four relos.

During the first four months of fiscal 2015 basically September through this coming calendar year-end, we planned to open eight of our fiscal ‘15 locations, six in the U.S. and one each in Australia and Mexico, as well we will complete one warehouse relo in Wayne, New Jersey. This will occur in two weeks from tomorrow on the 23rd.

This morning I will also review with you our membership trends and other activities, our e-commerce activities, additional discussion about margins and SG&A, our stock repurchase activities during the quarter. I will also comment on the recent switch in Canada of our co-branded credit card offering that's going on right now.

Okay, for the fourth quarter results, sales again, for the 16-week fourth quarter were up 9% to $34.8 billion, up $3 billion from $31.8 billion a year ago in the fourth quarter. On a reported comp basis, Q4 comp sales were up 6%. For the quarter our 6% reported comp was a combination of an average transaction increase of a little under 2% for the quarter and this included FX detriment about a 0.5% and average frequency increase of 4.2%.

In terms of sales comparisons by geographic region, in the U.S. with the 6% fourth quarter comp overall, most U.S. regions registered in the mid single-digit comp increases with Midwest and Southeast being even stronger.

Internationally, within the plus 8% local currency comp, Australia and Japan were the weakest, do in large part cannibalization with Taiwan, Korea, Canada and Mexico all coming in strong in terms of comp sales increases.

In terms of comp sales by merchandised categories for the quarter, both food and sundries and hardlines comps were both in the mid-single digits range for the quarter, and both softlines and fresh foods comps were in the high-single digits range for the fourth quarter. Within fresh foods, of course, we are still experiencing inflation in the low to mid single-digit range on average.

For our September sales results, sales for the five-week September month, which ended October 5th were $10.57 billion, up 7% from last year's September reporting period. Again, on a comp basis, reported plus 4%.

For September, our plus 4% reported comp sales results were a combination of a slightly positive average transaction, notwithstanding, almost 2 percentage points impact from FX and gas deflation, and average frequency increase of right at 4%.

Cannibalization for the month negatively impacted our sales by just under 0.5 percentage point. Excluding FX and gas effects, comp sales for the month of September as I mentioned were up 6%.

In terms of sales by geographic region, most U.S. regions were in the 4% to 5% comp sales range with Midwest and Southeast being even stronger. Internationally in local currencies, Japan and Australia being impacted by cannibalization were the weakest performers, while Canada and Taiwan were the strongest in terms of comp sales increases.

In terms of sales by category for the September, our food and sundries and softlines both enjoyed mid single-digit comps, hardlines low single-digit comps and fresh foods high single-digit comps, again having a little bit of extra inflation there as well.

In ancillary business comps, overall, in the mid-single digits led by optical and food courts. Our gas comps were in the mid single-digit range, despite average sale price of gasoline during the month being down 4 percentage points year-over-year.

Moving to the line items in the fourth quarter income statement. Membership fees, we came in at $768 million or 2.21% of sales, that's up 7% or $52 million year-over-year from $716. It’s down 4 basis points as a percent of sales. Again, we had strong sales in the quarter.

In terms of membership, we continue to enjoy strong renewal rates coming -- rounding up to 91% in the U.S. and Canada, and little over 87% worldwide. We continue to enjoy strength in our Executive member program with continued new signups.

New member signups in Q4 overall little over 2 million new signups in the company. This was about a 7% increase year-over-year. This was helped, of course, by strong new signups and a few overseas openings in Australia, Korea and Spain over the past year.

In terms of members -- number of members at Q4 end, our last reported number, of course, was fiscal quarter ago in mid-May. We had Gold Star members at the end of Q3 at 30.6 million, at the end of the fiscal year it was up 1 million to 31.6 million. Primary business was up 100,000 from 6.8 million to 6.9 million, add-ons remains at 3.5 million.

So, overall, total paid member households 40.9 million at Q3 end and up 1.1 million to 42 million even at Q4 end. I would -- excluding extra cards 74.6 million at Q3 end, up 1.8 million to 76.4 million at the end of the fiscal year.

Also at the end of the fiscal year, Executive membership's stood at just under 15 million, an increase of about 450,000 just in the 16-week quarter or about 28,000 increase per week of new Executive members.

In terms of membership renewal rates, they too continue strong. Again at the end of the third quarter, business renewal rates were 94.4%. They remained there at Q4 end. Gold Star renewal rates ticked up a little bit from 89.7% to 89.8%. Overall, we remained at 90.6%, rounding up to 91%. Again worldwide, we continued at 87.3%.

Now as I’ve touched on the last couple of quarters’ conference calls, we continue to try a few new things to drive both sales and new member signups. In early September, this would be the first couple weeks of the first quarter of the new fiscal year. For eight days, we ran a nationwide membership promotion for new members on Living Social with the purchase of a full price $55 membership. The new member received a $20 Costco Cash card, coupons for three free items.

As you might expect, they include a Kirkland Signature bath tissue, an apple pie, and rotisserie chicken, also a free three month membership for identity protection and a bonus coupon of $25 off of any Costco.com offer purchase of $250 or more. These types of promotions we believe will allow us to get in front of the other demographics and with an appealing offer. This one worked well and we’ll keep you posted.

Lastly, I want to mention that in Canada, it was announced last week that the Costco Canada's co-branded critical offering is being switched from a Costco American Express co-branded card to a new co-branded Costco Capital One Platinum MasterCard. This will be exclusive to Costco members. We've already begun to issue the new MasterCards and we will continue to accept all AmEx cards through December 31st of this year.

Our new no-annual-fee credit card doubles as the membership card and allows our members to earn cash rewards on all purchases made both inside and outside the Costco with no cap on the amount of rewards that can be earned. Getting back to the income statement, our gross margin in the fourth quarter was quite strong coming in up 15 basis points year-over-year from 10.55% year ago in the fourth to 10.70% during the fourth quarter of this last fiscal year.

As usual, I'll ask you to jot down a few numbers. We'll do four columns. This time the four columns -- the first two columns be for Q4 '14 both as reported and without gas inflation and then for the entire fiscal year '14 reported and without gas inflation or deflation.

First line item is core merchandise. In the fourth quarter, we have a year-over-year, core was up six basis points both with and without gas because gas year-over-year was essentially flat. For the year, plus 6 reported and a plus 3 without gas. Ancillary and other businesses, a big contributor in Q4 plus 15 basis points in the first two columns there and for the year plus 6 and plus 6.

The 2% reward no impact in the Q4 both in those two columns, a minus 1 basis point impact in the next two columns. LIFO, as I mentioned, of course, there was a charge this year versus a credit last year, 6 basis points year-over-year both in the fourth-quarter columns and minus 5 basis points year-over-year for the entire fiscal year in both columns.

Other, no additional items in the fourth quarter. In the last two columns for fiscal '14, minus 2 basis points year-over-year that related to a lawsuit recovery over a year ago that benefited us and of course, we didn't have any unusual item offsetting that benefit from a year ago. If you added up, we reported margins up 15 basis points both with and without gas.

Our reported total for the year was up 4 basis points but taking out gas, it was up one basis point. So again, a good showing overall in the fourth quarter in terms of margin improvement.

Now as I mentioned, the core was up 6 basis points. Two of the four core categories, food and sundries and fresh food show higher year-over-year gross margin percentages while year-over-year in Q4, softlines margins were essentially flat year-over-year and hardlines margins were slightly lower.

Ancillary business gross margins were up over 50 basis points year-over-year in the fourth quarter based on their own sales with gas, optical and hearing aids coming in better year-over-year in Q4. And LIFO again in the fourth quarter, we recorded just under $11 million or 3 basis point pretax charge compared to an $8 million or 3 basis point pretax credit last year for 6 basis point year-over-year swing in the fourth quarter.

Next our SG&A percentages, year-over-year in the fourth quarter, they were lower or better by two basis points coming in at 97.3% as percent of sales, compared to 97.5% last year. Again we'll do the same four columns, two for the fourth quarter with and without gas and two for the full fiscal year with reported and without gas.

In terms of core operations, we have two, a plus 7 and a plus 7 for the quarter and minus 2 and a plus 1 for the fiscal year. So plus 7 of course would mean that it was lower or better by that many basis points. Central was minus 7 and minus 7 for the quarter and minus 3 and minus 3 for the year.

RSUs a plus 2 and a plus 2 and for the year a minus 2 and a minus 2 and no quarterly adjustments. So total for the quarter both on reported basis without gas, again we were better by 2 basis point or plus 2. For the year, we are higher by seven basis points on a reported basis or minus 7 and without gas minus 4.

Now in terms of our SG&A performance, the core operations again was lower or better by seven basis points. Within core payroll -- within core, payroll and benefits expenses were lower or better year-over-year by 8 basis points, again helped by leveraging sales strength. Similarly other operating expenses as a percent of sales in the quarter were better by four basis points. So total between those two, those three items really would be 12 basis points.

The change in the bonus accrual year-over-year as I discussed earlier, hurt the core component by about five basis points. In terms of central, it was higher again by 7 basis points. About five of that is SG&A variance is related to the ongoing IT modernization efforts and another three is the increased SG&A expense resulting from the year-over-year swing in bonus accrual that's split between core and central.

And lastly our equity compensation, which is now an important component of the composition to again to about 4000 people. This represented an improvement of 2 basis point positive in SG&A, benefiting from both timing of certain vesting provisions when employees hit 25, 30 and 35 years of service as well as from the strong sales denominator in the fourth quarter.

Next on income statement line preopening, not a whole lot to talk about, $17 million last year in the quarter, $15 million of charges this year in the quarter. Last year, we opened seven units, this year 10, no major surprises there. All told, operating income in the fourth quarter increased 14% or $137 million year-over-year from $954 million last year in the fourth quarter to almost $1.1 billion, $1.91 billion this year in the fourth quarter.

Below the operating income line, reported interest expense was $1 million lower year-over-year coming in at $36 million last year and coming in this year at $35 million for the quarter. Interest income and other, it was lower year-over-year by $6 million, 36 million last year in the fourth quarter compared to $30 million this year. Actual interest income for the quarter was up $3 million coming in at $17 million, compared to $14 million last year.

The other component of interest income -- of interest income and other was lower by $8 million, primarily related to various FX items being mark-to-market at fiscal quarter end. Overall pretax income was up 14% or $132 million to $1.86 billion this year versus last year's fourth quarter, a pretax earnings of $954 million.

In terms of income taxes, tax rate for the quarter came in at 35.1, up three-tenth of a 1% from 34.8% tax rate all in last year. So slightly higher this year and as I explained the reasons for that earlier in the call. Overall net income was up 13% or $80 million to $697 million versus last year's fourth quarter of $617 million. And as I discussed earlier, this figure being achieved notwithstanding several items that in the aggregate did not go our way.

Now for quick rundown of other usual topics, the condensed balance sheet is included in this morning's press release with a couple of items from the balance sheet and the couple cash flow items I will point out here. Depreciation and amortization for the quarter totaled $321 million and for the year $1.29 billion.

In terms of accounts payable as a percent of inventory, on a reported basis both last year and this year's fourth quarter, it was right at 100%. Payables, of course, include things other than merchandise payables like construction payables. If you look at just merchandise payables as percent of inventory in both fiscal quarters, we were at 89% year-over-year. So almost 90% of our inventories being financed with trade payables.

Average inventory per warehouse, last year fourth quarter end, $12.5 million, up a tick this year in the fourth quarter at $12.8 million, we’re up about $300,000 or 2%. The $300,000 increase, about 80% of that is in four of our merchandised subdepartments. Majors was up about $91,000, some of that is the reintroduction of Apple products. Men's apparel was up about

$55,000. Foods was up $61,000 and meats were up $39,000, the latter two being somewhat related to inflation.

In terms of CapEx, in the fourth quarter we spent $567 million. For all of fiscal '14, total CapEx was right at $2 billion. Our estimate for fiscal '15 CapEx is quite a bit higher, probably in $2.5 billion to $2.7 billion range. The year-over-year increase in CapEx represents our plans for more openings this year that of course includes the four relos versus last year.

Increased spending for remodeling activities and expanding ancillary business operations, planned expansion of our cross-stock depot operations, anticipate spending later in the year for some additional openings earlier in fiscal -- in the subsequent fiscal year and increased level of IT spending for the modernization efforts.

In terms of Costco online, we're currently operated in four countries, U.S., Canada, U.K. and Mexico. We'd expect to be in at least one, probably two additional countries by the end of calendar '15. For the fiscal year, total e-commerce sales came in just under $3 billion.

For both fiscal fourth quarter and the fiscal year, sales and profits were up. Sales in e-commerce were up in the high teens for both the fourth quarter and the fiscal year and comp sales in e-commerce were up in the 18% to 19% range for both the fourth quarter and the fiscal year.

Over the past two years as I mentioned, we replatformed our site, we've introduced new apps. We've combined some e-commerce merchandising efforts within line efforts. We've added new categories including areas like apparel, health and beauty aids, and some sundries. And we've improved distribution and delivery time.

In addition, outside of e-commerce as you know, we've continued over the last -- much of this past calendar year testing Google Shopping Express. That continues with a great partner with Google. The trending is positive in terms of member spending and also signing up some new members. But again it’s still a test. We continued to add items to that delivery process. Currently, it's in three geographic areas, the Bay Area, Los Angeles and New York and more to come, I’m sure.

Next discussion in terms of expansion. Again for fiscal ’14 as ended, we opened 30. Acapulco was closed due to weather-related destruction, so ended up a net of increase last year of 29. This year, assuming, we opened the planned 31 and we open 35 but those are relos, so a planned net new of 31. Eight would be in the first quarter, none in the second quarter, two in the third quarter and 21 in the fourth quarter.

We’ve got a lot going on, I think, that again we will probably see, at least couple of them. One or two of those perhaps to be up a little bit, but few be pushed into the next -- early the next fiscal year. So in fiscal 14, we added 29 on a base of 634 or about 5% square footage growth.

In fiscal ’15, assuming 31, it will be about 4.5% to 5% square footage growth. In terms of the 31 this year, if we get all those open, 19 would be in the U.S., one each in Canada and the U.K. In Asia overall six, three in Korea, two in Japan and one in Taiwan, one additional in Australia that we are seventh in Australia, two more in Mexico and one more in Spain. As of Q4 end, total square footage stood at 95.3 million square feet.

One last comment regarding openings and operations in Cabo San Lucas Mexico, Costco like many other businesses was a victim of the recent hurricane on September ‘14th and the subsequent looting that took place and that we are currently closed. We plan to be back up and operating by early November.

In terms of common stock repurchases, we began our recent repurchasing activities on March 7th, the day after our second quarter earnings release was released. In Q3, we purchased 1.6 million shares at an average price of $113.14 for a total spend of just under $184 million. During the fourth quarter, we purchased 1.3 million shares at an average price of $116.11, or a total dollar amount of $150 million.

In terms of dividends, our current quarterly dividend stands at $0.355 a share or annualizes a $1.42, that's up 14.5% from the previous year's dividend rate. This $1.42 per share divided represents an annual cost of the company of about $625 million.

Lastly, our fiscal '15 first quarter scheduled earnings release date will be Thursday, December 11th, for that will be for the 12-week this first quarter ending on November 23rd.

With that, I'll turn it over to Brandy for Q&A. Brandy?

Question-and-Answer Session

Operator

(Operator Instructions) And your first question comes from John Heinbockel with Guggenheim Securities.

John Heinbockel - Guggenheim Securities

So, Richard, a few things, the gross margin being up in the food categories, is that cost of product to you? I know you talk about inflation, but is that cost of product driven, is that mix driven, where is that coming from?

Richard Galanti

Without looking at the detail, yes, most of it is cost of product driven. The examples of course would be, I mentioned before poultry prices to us have come down a little bit as we locked in versus where they had been. We didn't change the price, needless to say, of those items upward. I think we've had a little bit of hit in the food court similarly for that reason.

John Heinbockel - Guggenheim Securities

Do you think -- as Kirkland gets bigger and gets more scaled, do you think there is -- can that move the needle on gross margin either in terms of margin on the product or mix?

Richard Galanti

I think it does a couple of things. Generally, the answer is yes. And also as KS product takes share from a branded product, it generally move the branded product to come down and price to us, which again gives us even more competitive loyalty with our members. So there's a lot of good things there. Certainly, the needle -- the low-hanging fruit occurred many years ago. You've heard examples of, whether it’s toilet paper or disposable diapers where you have items that are very, very competitive branded items. We can come in with a great value, a great quality item and make a fairer margin to us but still a great savings to the customer. So it works but it moves the needle slightly.

John Heinbockel - Guggenheim Securities

One of the countries you didn’t talk about, good or bad was the U.K. Obviously there's a lot going on there. Just generally speaking, how do you find you are performing in the U.K. top and bottom line today?

Richard Galanti

Well, two things to finish some thing I thought about after I finished the first answer. The added benefit of course is not just KS but the increase in organic sales. That’s something I think that competitively gives us a leg up, because it's where more margin historically has been made in retail organic. We can provide better savings and has other positive attributes in terms of the type of member that shops with that stuff. In terms of the U.K., it was still positive. It was at the lower end low single digits. Actually, U.K. has shown some improvement.

John Heinbockel - Guggenheim Securities

You mentioned organic. Two things. What is happening to assortment there? And then secondly, it does look like on a variety of levels in terms of just product placement, marketing, you are trying to drive that significantly. So that’s got to be still one of the fastest-growing departments in food. Do you think that -- is that helping you much with the Millennials or is that yet to come?

Richard Galanti

Well, it's helping. It's probably a bigger percentage now because it's on a small base. You look at, I think couple of quarters ago I talked about like fresh ground beef, organic ground. It's an infinite percentage increase from 0 to 25 or so million of that first year. As I mentioned earlier, what we are finding with all of these items is that it's incremental sales because it was loyal members that didn't buy ground beef from us before, now they are. This year, organic ground beef sales were up dramatically because the supply is up dramatically. So, yes, again, there are big numbers on -- it's one of those good things but it's lots of little things.

John Heinbockel - Guggenheim Securities

Okay. Thank you.

Operator

Your next question comes from Peter Benedict with Robert Baird.

Peter Benedict - Robert Baird

Hey, Richard, couple of questions. First, just the membership promos you are doing with LivingSocial, how are those funded? Are the vendors contributing any of that or are you guys funding all that?

Richard Galanti

Take an example of -- I think we are doing most of the funding of that. Certainly to the extent, there is identity protection. We have some vendor support, I'm sure. I don't know exactly but I'm sure we do. The other items, on the food items, there are items, the KS bath tissue, rotisserie chicken. I'm not sure if there's a little support from the manufacturers but I would assume it's part of the member procurement costs on our side.

Peter Benedict - Robert Baird

All right. Okay. And then the plans for the Canadian cash that you're bringing in?

Richard Galanti

It’s really just moving it down here. As we read about everyday in the paper, money is stuck at multinational companies outside of the U.S. We have the ability -- based on when the monies were earned over the last 20 years. Years ago, basically the marginal, federal, corporate tax rate in Canada versus U.S. was a lot closer than I think the roughly 13 percentage points difference now roughly 26% versus 39%. These first billion dollars, if you will, bring in $2 million I think I mentioned is translated into U.S. dollars, is at an effective rate of about 1.25% tax rate. So we opted to move it. Canada, of course is very profitable. It has its own column in the segment analysis. You can kind of figure that out. While we are still adding two or three units, our CapEx is dwarfed by our earnings up there and so we will continue to make money. And we saw this as an opportune time to be able to start that process.

Peter Benedict - Robert Baird

Okay, perfect. And then last question just, how do you guys you think about the timing of introducing the executive membership option into new markets? What are the main considerations and how should we think about that for getting in some of these markets where you are not in? I’m thinking of Asia.

Richard Galanti

Yeah, I think there is two things. One is that how big is the country in terms of how many units we have. And secondly, can we get -- I guess there are three things. That was the first one.

Second would be putting a menu of services together that we can do. And of course as we get bigger and a relatively bigger in a given country that buying power allows us to do that. And then what else we have going on in using Japan as an example, we've gone from what 9 to 23 or 24 units in about 2.5 years. So I think we like it, we like executive member program, and long-term we would like to see it another countries, but those are the types of factors.

Peter Benedict - Robert Baird

Okay, great. Thanks very much.

Operator

Your next question comes from Scott Mushkin with Wolfe Research.

Mike Otway - Wolfe Research

Hey, good morning. This is actually Mike Otway in for Scott. Thanks for taking the questions. Richard, in terms of SG&A, you laid out the buckets. As we think about next year, is there any -- are there any buckets that are likely to move SG&A a bit higher than this year, or perhaps a little lower? I know you mentioned you are spending a bit more on IT modernization, how does that flow through the P&L? Any color there would be great.

Richard Galanti

Well, I mean, first and foremost, it’s sales growth. I mean, if we can get good sales growth, that helps a lot of things. Certainly, increased penetration in some of our overseas markets actually helps quite a bit, because of various things. The healthcare expenses as a percent of sales are much lower in virtually every other country than United States. Labor costs are different and generally lower in other countries as a percent of sales. So I think those things will probably help us.

In terms of IT modernization, as I’ve kind of laid out over the last couple of years each quarter, incrementally we would expect that to be in the low to mid -- low to low mid-teens incremental over a three or four years. I think we're probably up to 10 or 11 basis point or maybe 9 or 10 basis points over the last couple years and we will continue to see that this year. I don't think it's going to help us anytime soon. It probably is a slight negative impact certainly in fiscal '15, maybe a little in fiscal '16 before it flattens out and hopefully starts to go the other way a little bit.

Beyond that, healthcare is always none known in the U.S. And again as I mentioned, I think to the extent that the healthcare continues to be the inflationary aspects of healthcare in the US. And as you know, we haven't done -- aren't going to make major changes, like sending a bunch of people out of it. That's an expensive cost to us and we're probably be able do that. Notwithstanding that, even if that continues in its slightly greater than sale, topline sales rate of growth, increasing penetration of healthcare costs outside of the U.S. will help mitigate any damage there. So I don't think there's anything new to add to this process, those kinds of things.

Mike Otway - Wolfe Research

Okay, that's helpful. And then just in terms of the consumer, have you seen any real change there in the last few months? And then specifically with your business in the Midwest and Southeast, maybe what you're seeing in those regions relative to it's clearly strong, what's going on there versus some other places in the country?

Richard Galanti

Well, I think with Midwest, certainly it's a newer region relatively speaking. We are getting -- we seem to have I think hitting our sweet spots in some of those cities. Same in the Southeast, we've opened in areas like Louisiana and Alabama and Georgia and Florida with some additional units and South Carolina. They are generally tending to do pretty well. So I think a few actually years there have helped us frankly. I can't tell you much more than that in terms of the little color on the consumer.

Some of the usual suspects, good suspects if you will in terms of merchandise categories, some of the nonfoods, softlines and hardlines categories like apparel and housewares and domestics, those of all done well in part because of our commitment to them. Our increasing commitment of apparel area would be one example. Clearly having the demographic or member I think helps. Having strength in gas, I mean gas sales were up, I think I mentioned I think 4% -- notwithstanding -- 3% or 4%, notwithstanding 4% or so percent decline in average sales price per gallon. So gallons were up nicely and that’s driving, no pun intended but driving people into the Costco parking lots.

Mike Otway - Wolfe Research

Great. Thanks, Richard. Appreciate the color.

Operator

Your next question is from Meredith Adler with Barclays.

Meredith Adler - Barclays

Thanks for taking my question. I'd just like to talk a little bit about, as you think about international growth, I noticed that there's -- you didn’t mention opening anything in France, I think in this coming year. Are you looking just to continue to fill out the markets where you already operate? Or are you considering moving into another new market, and obviously Spain is still very new but…?

Richard Galanti

Sure. Well, both Spain and France, I think we probably started talking about those two countries three years ago. And at the time, we felt that it could be three or more years based on the permitting and appeal processes and various not only countries, but cities and communities. And that’s certainly why we keep at this point pushing out France, we will continue to look at that. And again, we will have our second opening in Spain later in calendar

’15. We haven't mentioned any other countries beyond that. If I was a betting person, absolutely in the few years but not in the next year, year and half.

Meredith Adler - Barclays

And maybe you could just comment a little bit about real estate in the U.S., are you finding any changes in the environments, harder to find locations, working with developers, anything different?

Richard Galanti

Well, I don’t know if it’s anything different. In some of the markets, it becomes -- it’s ever increase -- increasingly more difficult. In the greater LA where we've got 40 or 50 units, many, many units, we feel that over the next 10 years we could open another 10 or 15, but they are all very pinpointed locations based on where other locations, other Costco locations are, so it’s -- and it’s densely populated and it’s difficult, but that's what we do.

And we’ve got a lot more people in the real estate area over the last few years, we’ve got more in the pipeline and we think we’ll get there. I think also in -- and we are fortunate of the sense that many of the markets, be it Texas, Midwest, Southeast, some of the markets that we are newer and over the last 10 years, not the last 30 years, we’re able to go into. And again given our demographic, we’re able to find some locations. Certainly, we also get some calls as you might expect from developers, but it's probably an increasingly difficult effort and that's why we've added more infrastructure to pursue that.

Overseas every country is a little different. I think as I mentioned in Asia this coming year we have I think six plan 3, 2 and 1. Of course we’ve opened a bunch in Japan in last two years already. And so again it takes a lot longer, but we’ve got a lot in the pipeline too and so we will continue to see some growth there.

Meredith Adler - Barclays

Okay, great. Thank you.

Operator

Your next question is from Simon Gutman with Morgan Stanley.

Joshua Siber - Morgan Stanley

Good morning. It's Joshua Siber on for Simon Gutman. I am curious, if you guys are seeing areas of the store where customers are more or less sensitive to price increases and how much room you have to further pass-through greater costs in these categories?

Richard Galanti

Well, we're most sensitive to us. We haven't seen any major change in level of competition out there, I mean everybody is tough and we're pretty tough ourselves. So I don't think so. I mean, I think, it's continuing as it goes. I think some of our margin improvement of late has become as we have not raised prices, but some of the underlying costs have come down and some of that hurt is behind us, but tomorrow is another day.

Joshua Siber - Morgan Stanley

Okay. Sorry. Go ahead.

Richard Galanti

The list of price increases is not a big list around here.

Joshua Siber - Morgan Stanley

Okay. That's helpful.

Richard Galanti

Relatively speaking.

Joshua Siber - Morgan Stanley

Sure. For the members that you picked up on LivingSocial, do these customers shop online more frequently and is there a noticeable difference in basket in terms of pricing or content?

Richard Galanti

They are so new, I can't really tell you. This most recent program was early about three weeks ago and the process is they redeem their coupon, then they come in and a lot of them are coming in. But I would guess generally speaking compared to the first test we did on a regional basis within social a few months earlier, you do have a higher percentage of millennials. But by getting new member millennials or otherwise, when new member first starts to shop, they are generally shopping small basket sizes and a little bit more food-oriented to start with. And that's been historically a typical for -- a typically pattern. So, it's too early to tell.

Joshua Siber - Morgan Stanley

Okay. And then just one more housekeeping question. Is the $150 million buyback that you guys spent in fourth quarter a good run rate to go forward?

Richard Galanti

I can't really respond to that. I can tell you that we -- historically when we have bought back we have bought through blackout periods using 10b5-1s, our longest blackout period of the year which is six or seven weeks long, stretching from early -- I guess from late July, early August all the way to today.

You have to basically put in place something. Well, if you go back that many weeks, the stock at the time was in the mid to high, 115 to 117. And so we hadn't bought for the last few weeks of the quarter, but that would imply a little longer, a bigger run rate, but it will go up and down a little bit. I think that we are intent on buying some stock back.

Joshua Siber - Morgan Stanley

Okay. Thanks for the color, guys.

Operator

Your next question is from David Schick with Stifel.

David Schick - Stifel

Hi. Good morning. You talked in the call about the high-teens growth of online and you talked about the success of the Google partnership. And you said profit growth was I think at a similar pace. But going back to what you said; if you could just give any more details on how the profitability or the growth thereof is trending in online, that would be helpful. Thanks.

Richard Galanti

The profit was very good. I don’t think we really give out profit growth numbers there and that 3% piece of our business. The good news, it’s growing and it is more profitable. E-commerce is definitely quite a bit more profitable than the rest of the company. And so 3% of sales implies a greater percent increase of earnings.

David Schick - Stifel

Is it more profitable on a flow-through basis than it was at this time last year?

Richard Galanti

Let me correct that, 3% of sales, a higher percent of sales profitability than the company overall. So every time we can grow those sales, you will see earnings grow nicely too.

David Schick - Stifel

And then is the operating margin of it -- if you don’t want to detail that, that's fine, but is it growing beyond the revenue, is it levering, or is it expanding the total loaded margin?

Richard Galanti

Well, the problem you’ve is that we’ve opened recently in a couple of new countries in the last year and half. And so we’re spending a lot of money on that. We spent a lot money on apps upgrading. And so I don’t have the numbers in front of me, but I know it’s growing and it’s profitable. And we are continuing to pursue it.

David Schick - Stifel

Thank you.

Operator

Your next question is from Greg Melich with ISI Group.

Greg Melich - ISI Group

Hi. Thanks, Richard. A couple questions. Love to start on membership fee income, so it was up 7%, what was it in local currencies? And in terms of membership growth, how much of that you think is driven by the new clubs?

Richard Galanti

Let me answer the first question. It was up 8% without FX and dollars. And what was the other question?

Greg Melich - ISI Group

So I think you said memberships were up 7%. I was trying to get a sense of how much of that was driven by the new openings, particularly in these markets where you have been very successful and you've had huge membership growth with some of the new clubs.

Richard Galanti

I don’t have it in front of me. I’m sure that made it healthy. I can remember over the years when sometimes it’s a little down year-over-year because a year ago we had some foreign operations with those outsized, new sign-ups and fewer international the next year. I don't know off the top of my head.

Greg Melich - ISI Group

All right. So use 8% as the local currency number?

Richard Galanti

Yes.

Greg Melich - ISI Group

Okay. And then second, I wanted to understand a little bit more about the gross margin in ancillary. I guess that was up -- you said up 50 bps in ancillary, which was 50?

Richard Galanti

The ancillary, if you totaled ancillary gross margin divided by total ancillary business sales, it was up a little over 50 basis points. Different ancillary businesses were up or down differently, that in addition to strong sales in those areas. So the combination of increasing penetration and increasing margins was at a higher level benefit to the total company gross margin. Gas being the outsized one there.

Greg Melich - ISI Group

How should we think about the sustainability of that on gas? Like, are we now at what would be a normal run rate there? And also is dot-com -- where does that show up in your nice little bridge you do?

Richard Galanti

Well, dot-com is in the core. It’s on percent…

Greg Melich - ISI Group

Okay. That’s the reason.

Richard Galanti

Dot-com, no. In terms of sustainability of gas profits, I only wish. We’ve probably been on a little longer run of good gas profitability the last several months. Generally speaking, when gas prices year-over-year are flat or declining as they are now that's good news. We save the customer more and we make more.

When they are growing up fast, we save the company and the customer little less and we make it less. And so we've been blessed by having a positive run here for several months. But it’s a volatile area. Now that’s just looking with false blinds on just gas operation. That doesn’t take into the account fact that every time we can get somebody to come in and get gas. That’s incrementally a potential positive shop in the warehouse as well as and so that we of course don't consider is part of that.

Greg Melich - ISI Group

Is it fair to say that the 15 bps that you cited that gas was half of that? I think you listed it first when you talked about optical and hearing aids and gas.

Richard Galanti

I don’t know off the top of my head. I bet it’s half or more. It’s not all.

Greg Melich - ISI Group

Got it. And then lastly just on the inventory increase, it sounded like you gave those four areas which is all very clear. Was there anything unusual about that other than restocking Apple that you wouldn't use that as sort of a trend going forward in those categories?

Richard Galanti

Actually, the trend -- this is, I think probably the lowest year-over-year average increase in merchandised inventories. For few years there, we've been running up 5%, 6%, 7%, 8% year-over-year in the inventory levels. In the last couple of quarters on a year-over-year basis, we've been down in the 2% or 3% range.

So actually it’s come in better in my view, I mean, 2%, whatever a 3% increase in inventories on a 2% increase in inventories on a 7%, or 8% or 9% increase in total sales. I think the anomaly there would be adding some product on that side and the anomaly, of course with inflation and fresh foods. But that’s going to fluctuate as well. So, I think overall probably this is -- we looked at this as being a little bit better level of increase in average inventories per warehouse.

Greg Melich - ISI Group

And it sounds like you think it's sustainable at this rate?

Richard Galanti

At this point, are you sure?

Greg Melich - ISI Group

Yeah. Thanks a lot.

Richard Galanti

That could change tomorrow. You never know.

Greg Melich - ISI Group

I know. Thanks a lot.

Operator

Your next question is from Mathew Fassler with Goldman Sachs.

Mathew Fassler - Goldman Sachs

Thanks a lot and good morning. A couple of quick ones here. First of all, I know that you essentially mark-to-market for LIFO at the end of any given quarter or so. So your expectation is that you are probably going to be clean as you go into next year. That being said with the trends that you're seeing in pricing in key categories, what is your initial thinking on the direction that might move in 2015 relative to this past year?

Richard Galanti

It’s hard to know. The only person, I’ve actually talk to is in the area of fresh foods and there's anticipation of continuing overall inflationary trend there. Although some of it, when it's deflationary, it’s because -- I think butter had skyrocketed and now it’s coming down a little. I might be wrong on the commodity there but probably still a little bit of inflation.

Mathew Fassler - Goldman Sachs

Okay. A quick second question here. You mentioned in your gross margin discussion that a hard line was down a bit year-on-year. Just interested in any color in terms of the drivers there?

Richard Galanti

Yeah. I think, for the quarter it was flat. Nothing really stood out. I mean, majors versus electronics was up slightly, nothing really stands out there.

Mathew Fassler - Goldman Sachs

Okay. And then finally, you had a question earlier about some of the membership deals that you are running, for example, the one with LivingSocial but really who bore the economic costs. I guess my question is, and I know that this is pretty small potatoes for the moment, how do you account for those subsidies? Does it reduce the membership fee income or does it show up in some other line item?

Richard Galanti

It’s allocated between sales and membership but it’s mostly membership.

Mathew Fassler - Goldman Sachs

Okay. So for the year -- sorry go ahead.

Richard Galanti

That’s over the year. I mean, and it’s amortized over the year. I will have to find out. I don’t -- it's so small. It’s less than a rounding error.

Mathew Fassler - Goldman Sachs

Fair enough. Okay. I appreciate it. Thank you.

Richard Galanti

Is that it?

Operator

Your next question comes from Charles Grom with Sterne Agee.

Charles Grom - Sterne Agee

Thanks. Good morning, Richard. Nice quarter. Just wanted to see if you could talk a little bit about Google Express and what’s the ultimate goal of that program? Is it to drive increased memberships? Is it for you to get younger? And I guess what's holding you guys back on rolling it out to more than just the few regions where it's being tested today?

Richard Galanti

Well, first of all we talk about us and Google partnering on this. They're partnering with a number of other retailers as well. You can go to Google Shopping Express in each of those three geographic markets and see about other retailers. We're certainly, I think a big component of it but we're big component of anything we do. And it's been good so far. I think you really have to ask them that. I would assume they are looking at additional markets but as they are announced, you'll find out as well.

Generally speaking, ultimately, we always asked about all the concerns with delivery and e-commerce and all that stuff. And we recognize, we're not going to be the guy that drops off Fruity Pebbles cereal and a quarter milk before your kid wakes up in the morning for breakfast, if you ordered it before 10 p.m. a night before. But we started our business being a wholesale supplier. In this case, it's kind of hopefully a win-win, not only for Google Shopping Express but for us.

We are seeing incremental business from it but there is -- again there is a lot of nuances to it, so far so good. But again, the biggest test it's been around for seven -- eight or nine months I guess, since January in the Bay Area and a lot fewer months in L.A. and New York. We like it because it's our member and there is net positive aspect of it. You can't get Costco items through Google Express unless you are a Costco member. And we have seen incremental signups because of that.

And look, we appreciate the fact that it's a way to self merchandise, as well it's a way to get some members over time as well it's a great way in our view to have -- ultimately, we want to get you into the store or into warehouses more frequently also and we think there's avenues to do that. But it's really too early to know other than as its likely rolled out to other cities. We'll be part of that at this point in time.

Charles Grom - Sterne, Agee

Okay. So another initiative you guys have is to get younger is this organic offering. I'm just wondering if you could just put things into context of where you guys are today, either number of SKUs or percentage of sales, to where you were a couple of years ago.

Richard Galanti

Organic was about $3 billion I’m told by one of the many people in my office right now last year and growing dramatically, a part of that supply and part of that’s pushing it more. I don’t think we said around the number of years ago and said let’s do organic to get millennials. I think what happened is as we saw items and as those items grow and we see that it’s got great attributes for us. Wonder we didn’t even realize until we saw it.

We can generally provide a better savings than others because other retailers sometimes will use it as an ability to get more margins and so it show greater savings. It’s a higher price point item than the substitute item. And again the added benefit was as in some instances, I’ve used the ground beef example.

We had existing loyal members that 80%, I know in the first year assume it could be a little lower. Now but a large percentage of those were incremental sales because those were existing members that didn’t buy their ground beef at Costco. So to the extent that you have, be it Millennial or otherwise but to the extent, you have somebody that is an organic buyer that may have left Costco but if we don’t have an organic alternative, they go to shop elsewhere for that item.

Now, so that helps unforgettably more frequently to Costco but we’re doing it because we’re selling those items. And as it increases -- we've had organic milk for a number of years and certainly we’re able to use our buying power and our sourcing to continue to drive that.

Charles Grom - Sterne, Agee

Okay. And just switching gears a little bit, it's been a while since I've heard you guys articulate a longer-term store goal. And I'm just wondering if you are willing to share one now. And as a follow-up to that, 19 clubs in the U.S this year out of, say, roughly 31. When does the pendulum shift to more international locations where you are doing 19 international, say, as opposed to 19 in the U.S. for this year?

Richard Galanti

I think over the next five years. If you look that a year ago, I think, we talked about the fact that over a five-year period we'd expect to open roughly 30 a year, maybe starting at 28 or 29 and after 33 or 35 and we're kind of in that. I guess, you're two or two and a half of that five years. I think the fact that we're opening a few more -- if you ask me four years ago, I would guess, it might be more evenly split right now. I think that's simply a function of availability and speed at which you get things done here.

When you're looking at 20 million population city in Asia, there is all kinds of issues and again, as I've mentioned, we've got more people in real estate on the ground in each of these countries compared to very few on the ground five years ago.

So the pipeline is definitely more filled. And I guess, from -- looking at it in a positive way, I -- the question of, when do you going to slowdown in the U.S because of anticipated saturation, where -- I am happy to report that that's not happening yet.

It will happen at some point, but if anything, it's probably that pendulum has probably swung the other way a little bit in the last couple years in part because some of the strength in those markets where we've been in 10 to 15 years or less not 25 and 30 years.

Charles Grom - Sterne, Agee

Interesting. And any thought on a longer term store goal that you guys have?

Richard Galanti

Other than more, I think, if you ask, Jeff and Craig and the heads of operations, if it were this current might, as I defined it five-year period, its 30 -- a little over 30-year. I think we like to get up to 35 a year in the next five years, maybe a little more. So we'll continue to try to push that a little bit and we feel we have the capabilities to do that that depends of course on continued success in these markets.

Charles Grom - Sterne, Agee

Okay. And then the last question just on the margins as a follow-up to I believe Matt's question, just wondering if you could speak to the degree of improvement on food and sundries and fresh relative to the third quarter, which I believe your food and sundries was up 20 and then fresh was down a couple of basis points? I know you said it was positive, just wondering if you could give us the degree of improvement?

Richard Galanti

I think it's in the -- I don't have it right in front of me, but it was less than up 50 and more than up 10, I don't have it in front of me.

Charles Grom - Sterne, Agee

I'm sorry, could you repeat that?

Richard Galanti

Less than up 50 and more than up 10 basis points.

Charles Grom - Sterne, Agee

Okay.

Richard Galanti

I think, somewhere in the high teens or 20s, I don't -- I could be off a little bit, but there wasn't -- one of them wasn't up 1 basis point and the other up 80. They were both up.

Charles Grom - Sterne, Agee

Okay. Okay. Great. Thanks again.

Operator

Your next question is from Michael Exstein with Credit Suisse.

Charlene Wong - Credit Suisse

Morning. It's Charlene Wong on for Michael Exstein. What's your initial experience in Spain been like?

Richard Galanti

I'm sorry. What was the question?

Charlene Wong - Credit Suisse

What has your initial experience in Spain been like?

Richard Galanti

Well, so far, it's fine. I mean, our member signups are strong and continuing. As we expect when we go into a completely new country, you generally see smaller baskets to start with. We haven't -- needless to say, we've only been here for three or four months so we haven't anniversaried anything in terms of seeing any type of renewal rates. But we're pushing forward. We're working on our sites in Spain. So, no major differences of expectations.

Charlene Wong - Credit Suisse

Got you. Thank you.

Operator

And your final question comes from Bob Drbul with Nomura Securities.

Bob Drbul - Nomura Securities

Hi, Richard. Just got a couple of questions for you, though. On the fourth quarter what was the percentage of sales to the total and I'm not sure if you gave it, but can you talk a little bit about in September the impact on gas and FX were to the month of September sales?

Richard Galanti

Yes. I can. Gas was, well, let’s say, FX was 120 drag and gas was about 0.5 a point, just 48 basis points.

Bob Drbul - Nomura Securities

Okay. Great. And then just the last question that I have is, on the openings for the next fiscal year, are you -- the timing of them, why are they so back-half weighted?

Richard Galanti

Well, the biggest reason is, we try to open everything as soon as we can, other than when there's some craziness, because if it’s up in Minnesota and its in the snow and the grounds frozen, you might lose four months and you can’t get the foundation, the ground dug and the foundation set.

But it's just timing of when they are. We would love to push a few of them sooner. That’s generally our best guess of where they are. Its really, I mean, the impact is and I’m sure by Q3 as we know more specifics about how many will open we will have a little color on pre-opening expense. But other than that it’s a manageable process.

Bob Drbul - Nomura Securities

Great. Thanks very much.

Operator

And there are no additional questions at this time.

Richard Galanti

Well, thank you very much. And Bob and Jeff and I will be in the second day of our budget meeting for a couple hours but feel free to leave the message. We'll get back to you after noon. Thank you.

Operator

Thank you. Ladies and gentlemen, this does conclude today's conference call. You may now disconnect your lines.