Costco Wholesale Corporation (NASDAQ:COST) Q1 2015 Results Earnings Conference Call December 10, 2014 11:00 AM ET

Executives

Richard Galanti - Chief Financial Officer

Analysts

John Heinbockel - Guggenheim Securities

Joshua Siber - Morgan Stanley

Charles Grom - Sterne, Agee

Brian Nagel - Oppenheimer

Dan Binder - Jefferies

Meredith Adler - Barclays

Mark Miller - William Blair

Chris Horvers - J.P. Morgan

Kevin Heenan - Nomura Securities

Oliver Chen - Cowen and Company

Matt Fassler - Goldman Sachs

Chuck Cerankosky - Northcoast Research

Mike Otway - Wolfe Research

Robby Ohmes - Bank of America Merrill Lynch

Greg Melich - Evercore

Joe Feldman - Telsey Advisory Group

Operator

Good morning. My name is Erica, and I will be your conference operator today. At this time, I would like to welcome everyone to the Q1 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. And I would now like to turn the call over to Mr. Richard Galanti, CFO. Mr. Galanti, you may begin your conference.

Richard Galanti

Thank you, Erica. Good morning to everyone. This morning’s press release reviews our first quarter fiscal 2015 operating results for the 12 weeks ended November 23rd.

I’ll start by stating that the discussions we are having include -- 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 first quarter operating results for the quarter as you saw we -- our reported earnings came in at a $1.12 a share, up 17%, or $0.16 per share over last year's first quarter earnings of $0.96 a share.

Few items of note, in terms of looking at the comparison, within gross margin which was higher year-over-year in the first quarter by 22 basis points, we benefited from strong margins in our gasoline business, which I will speak to more when I discuss our gross margins results and we also had a $17 million pretax nonrecurring loss recovery. This latter $17 million amount represented about 6 basis points in margin improvement or about $0.03 to our per share earnings.

Interest income and other, you note was higher year-over-year in the first quarter by $17 million pretax or about $0.03 a share. This increase primarily related to several of our foreign operations using FX contracts to lock in U.S. dollar denominated merchandise payables. Under GAAP, the mark-to-market gains or losses, in this case, of course, gains are recorded on the interest income and other income statement line.

I really look at this is part of merchandising gross margin in the sense that our foreign operations -- our foreign operations buyers lock in exchange rates at prices -- at amount which they are comfortable they will be able to price their merchandise at.

Third, FX, in the first quarter, as you probably are aware, the foreign currencies where we operate overall weakened versus the U.S. dollar, primarily in Canada and Japan, resulting in our foreign earnings in the first quarter, when converted into U.S. dollars being lower by about $22 million pretax or $0.03 a share than those earnings would have been had FX exchange rates been flat year-over-year.

Fourth item, stock expense, that was higher year-over-year in the first quarter by $38 million or $0.06 a share. As I mentioned before, we have over 4,000 of our assistant managers and above, who receive restricted stock units as a significant part of their annual compensation.

These grants are made annually each October or in the first fiscal quarter. These RSU grants then typically vest over a five-year period, with accelerated vesting when a recipient reaches 25, 30, and 35 years of employment with the company.

Factors driving this increase included, of course, the appreciation of our stock price, additional levels of accelerated vesting given some employees' long tenure with the company and large number of employees in the plan. I should note that last past October, our RSU grants were reduced by an average of 15%. That is the number of RSUs granted to each recipient.

Fifth, IT modernization costs, as discussed in each of the past eight or so fiscal quarter's earnings calls. Our major IT modernization efforts continue to negatively impact our SG&A expense percentages through '15 and into probably the first half of '16, especially as these new systems are placed into service and depreciation begins.

In the first quarter, on an incremental year-over-year basis, these costs -- these incremental costs impacted SG&A by $12 million on estimated 3 basis points or $0.02 a share.

Turning to our first quarter sales, in terms of the sales for the quarter, our 12-week reported comp sales figures for Q1 showed a 5% increase on a reported basis, 6% in the U.S. and 1% internationally.

As indicated in our release, excluding gas price deflation and the impact of FX, the 6% U.S. would have been 7%, the 1% international would also have been 7% and therefore, the 5% for the total company reported on a normalized basis would have been 7%.

And as reported last, Thursday, our November sales results for the four-week month ended November 30th, our comp sales increase, excluding again the impact of FX and gas were even a big stronger than these 12 weeks figures, with total company comps on that normalized basis increase of 8%, which included a 9% in the U.S. and 7% international ex gas and FX.

Other topics of interest, our opening activities and plans, we opened eight new locations during the first quarter, which ended November 23rd, six in the U.S., our seventh location in Australia and our second location in Leone, Mexico. During the first quarter, we also relocated one location in Wayne, New Jersey to an expanded location.

Also during the quarter we -- about six weeks prior we had experienced a severe hurricane in -- around our Campos and Lucas, Mexico location that has since been reopened.

We have no openings plan for Q2, for all of fiscal ’15 however, we have a current plan of 31 new locations, 18 of which will be in the U.S., three each in Japan and Mexico, two each in Australia and Korea, and one each in Canada, U.K. and Taiwan.

Also this morning, I will review with you our e-commerce activities, our membership trends, additional discussion about gross margins and SG&A in the quarter, and just few other topics of interest.

Now on to the discussion of our quarterly results, again sales, total sales were up 7.4% to $26.3 million. Again, on a comp basis, reported a 5, ex gas and FX it would have been a 7.

For the quarter, our reported [five] [ph] comp was a combination of an average transaction size of just over flat for the quarter, ex gas and FX it would have been up about 2.5% and average frequency increase of about 4.5% in the quarter.

In terms of comparisons by geographic region, geographically for the quarter, at the Midwest and Southeast were the strongest with Northeast close behind. Internationally in local currencies, the better performing countries were Canada, Taiwan and Mexico.

In terms of merchandise categories for the quarter, for the first quarter within food and sundries which was up in the mid-single digits. Candy, deli and spirits were up with the relative standouts.

Within hardlines, there were also up in the mid-single digits for the quarter. Majors are electronics, came in positive for quarter actually in the high-single digits range. In addition, better performing departments within hardlines was a hardware, sporting goods and tires.

Within mid single-digit softlines, domestic, apparel and home furnishings were the standouts and fresh foods, where our comps were in the high singles, with meat department being the standout there.

Moving to line items in the income statement, the first quarter, membership fees, were up 6% or $33 million to $582 million. That was about -- even the sales strength that was about 3 basis points decline. Again, ex-FX at 6% dollar increase, if assuming flat year-over-year FX would have been up 8%.

In terms of membership, we continue to benefit from strong signups at existing and new warehouses, continued increase in penetration of the executive member and strong renewal rates both in the U.S. and Canada, as well as worldwide in newer markets.

Our new membership signups in Q1 year-over-year companywide were up 4% year-over-year in the quarter. You know, there were fewer locations opened. We opened nine locations in Q1 this year versus 13 last year. But that, of course, includes all member signups, new member signups throughout the company.

In terms of new number of members at Q1 end, we began the fiscal year or ended last fiscal year with 31.6 million Gold Star members. We now had this quarter end 32.1 million, so up about 0.5 million.

Primary business remained at 6.9 million, Add On Business remains at 3.5. So all told, we went from 42 million member households to 42.5 million and including additional card -- cardholders went from 76.4 million in fiscal year end to 77.5 million at the end of the first quarter.

Also at Q1 end, paid executive memberships totaled 15.2 million, which was an increase during the 12 weeks of about 420,000 or about 35,000 a week increase in the quarter. Executive members as you know represent more than a third of our membership base and over two thirds of our sales operation.

In terms of renewal rates, they continued to be strong. At the end of the fourth quarter business memberships renewed at 94.4 at Q1 ’15, so 12 weeks later 94.5 up a tick, Gold Star remained at 89.8, total 90.6 at fiscal year end and 90.7 at Q1 end and when I say total, that’s U.S. and Canada, recognizing newer markets start out lower rates and build over the first several years.

Worldwide we remained at 87.3% in the fourth quarter and at Q1 end still a nice increase from year earlier at the end of the first quarter last year at 87.3 that we ended the quarter with now was 86.5 worldwide.

As I touched on last quarter’s conference call, we continue to try new things to drive sales and members, membership signups. I did mentioned in this fiscal quarter, but I -- on the last call in early September for eight days we ran a nationwide promotion for new members on LivingSocial. It was a good value and we felt worked pretty well, but we will continue to look and see what we want to do going forward, no plans at this point.

Going on to the gross margin line, gross margins as you saw were quite strong up 22 basis points to 11.03%. Again, I'll ask you to jot down a few numbers, well, our four columns, the first two columns are for the entire fiscal year ’14, both reported and without gas deflation and then first quarter ‘15 would be columns three and four reported and without gas deflation.

Moving across those lines -- those columns, core merchandise for the year was up 6 basis points on a reported basis and up 3 ex gas deflation. For the quarter, it was down 6 basis points and down 13 without gas deflation.

Ancillary, plus 6 and plus 6 in columns one and two for all of last fiscal year. In Q1 ‘15 reported plus 22 and without gas deflation plus 20. 2% reward, minus 1s across the four columns.

LIFO year-over-year and for the -- for all of last fiscal year was a minus 5 and a minus 5, we actually had a very small LIFO credit this year versus a very small LIFO charge last year in the quarter, so it’s a plus 1 and a plus 1.

Lastly, other adjustments, minus 2 and minus 2 in all of fiscal '14 and plus 6 and plus 7 without gas deflation for Q1, that's that one-time, that nonrecurring lawsuit recovery as I mentioned earlier. So total reported was up 22 and for the quarter and up 14 without gas deflation.

Now the core merchandise I mentioned is, on a reported basis was down 6 and down 13 ex gas, a lot of that again is driven by this -- particular the success in the gas business both in volume, as well as margin contribution, where gas margins were up when gas prices will go down typically.

Core gross margins as a percent of their own sales were slightly negative, a couple basis points down year-over-year, with food and sundries and softlines -- and softlines showing year-over-year improvement, and hardlines and fresh foods gross margins being lower year-over-year in the quarter, pretty much as what we planned -- what we continue to see in the fresh foods area with some of the raw material costs going up.

Ancillary and other business gross margins, as I mentioned, was up 22 or up 20 without gas deflation. With the exception of pharm -- slightly lower -- lower year-over-year pharmacy margins, most of the other ancillary businesses starting with gasoline, of course, but optical, hearing aid, travel business centers all showed higher margins year-over-year in the quarter.

2% reward, again increasing penetration represented a basis point hit to margin and as I mentioned, LIFO was a 1 basis point swing, we had a $1 million LIFO charge last year in the quarter and a small LIFO credit of about $2 billion this year.

Moving into SG&A, our SG&A percentage year-over-year in the quarter was higher by 5 -- by 4 basis points coming in at 10.26 this year compared with a 10.22 last year in the quarter. Again, we'll do the same four columns for all of fiscal '14 both reported and without gas deflation. Columns three and four first quarter both reported and without gas deflation.

Going across these line items, operations were a minus 2 and a plus 1 for the year and a plus 8 and plus 16 for the quarter. Remember pluses means lower year-over-year SG&A. Central, minus 3 and minus 3 in the year and minus 1 and minus 1 in the quarter. Stock compensation minus 2 and minus 2 for the year and minus 11 and minus 11 for the quarter and total would be again for reported for all of fiscal '14 SG&A was higher year-over-year by 7 basis points, without gas deflation higher by 4, this year in the first quarter it was higher by 4 reported and better or lower by 4 without gas deflation.

And little elaboration on this, core operations SG&A again was lower by 8, but lower by 16 ex gas impact. Within operations without gas our payroll SG&A percentage was 9 basis points better year-over-year, particularly good showing and certainly a reflection of a strong sales, as well as strong gas sales which have lower SG&A. While benefits to workers comp related expenses were about 4 basis points worse year-over-year.

Central expense was slightly higher year-over-year in the quarter by a basis point, increase IT spending is, we continue to monetize, as I mentioned, within this number that was about 3 minus -- minus 3 basis points and that will continue in those types of increments we think. The increase was partially offset, of course, by improved payroll in central, as well as by 2 basis points.

Finally, SG&A expense related to stock compensation was higher year-over-year by 11. I should point out that the year-over-year basis points variances for the six months item will be quite a bit less in Qs 2 and 3, and higher year-over-year in Q4, but not as big negative as variances we've seen in Q1.

Again, if you think about it, with most of the option -- most of the RSUs vesting over five years, you take out the one that -- finally vested, so you take out the expense back when the stock was in the 50s and you add one when the stock was in the 125, 130s when we did that one in October this year.

All told, hold on, here, last thing, on the income statement pre-opening expense, $24 million last year, it was lower or better improvement by 15 -- by 9 million or 15 million this year. Again, we opened nine units this year compared to 13 last year.

So all told, reported operating income for the quarter totaled $668 million last year and $770 million this year, an increase of 15% or up $102 million in the quarter. Below the operating income line, reported interest expense was about the same year-over-year with Q1 '15 coming in at $26 million versus $27 million last year in the quarter.

Interest income and others I mentioned earlier was quite a bit higher year-over-year, $18 million last year versus $35 million this year, up $17 million. Actual interest income reported for the quarter was slightly up, I think it was little less than a $1 million.

The other component of equity earnings within this line item was higher by 16. This again relates to this marking to market gains on FX contracts used to -- used to source U.S. merchandise in our U.S. -- principally our U.S. merchandise in our international operations.

Overall pretax income was up 18% versus last year's quarter from $659 million last year to $779 million this year. In terms of tax rates, our effective tax rate this quarter came in a little higher than last year. It came in at a 35.2% compared to last year's first quarter rate of 34.6%. The decrease is mostly due do to a few net discrete items that benefited last year by about $5 million and a couple of a negative discrete items, which totaled about an increase in the taxes of about $1 million this year.

Overall net income was up 17% versus last year's first quarter from $425 million last year to $486 million this year. Quick rundown on couple of other topics. Balance sheet, depreciation and amortization for the quarter came in at $254 million. In terms of accounts payables as a percent of inventories, you have the balance sheet attached to press release.

Now, on that, it showed a reported number this year of 101% payables to inventories, up about two percentage points from 99% last year. That of course includes construction payables and other payables not just merchandise.

We took up everything and just said merchandise payables as percent of inventory. Last year in Q1, it was 89%, up three percentage points to 92% this year. Again I think, a reflection of good inventory control but also strong sales. Average inventory per warehouse last year in the first quarter ended at $14,453,000. This year came in slightly lower at 14,372,000 about $81,000 lower.

If you take out FX, FX was about a minus 250 -- $250,000 to that number. So if you take out FX, we are actually up average inventory per warehouse of about $169 million, still a very small increase of 1.2% on that normalized basis compared to the 7 plus percent sales increase.

No real issues with inventory levels going into last few weeks before calendar year and Christmas for the holidays. They are in good shape. In the past couple of months, we have received questions about possible inventory issues due to the work slowdowns and shipping along the West Coast. I'm sure like many retailers, we did what we always do to bring in seasonal merchandise a little earlier if required and necessary.

Overall it was not a big issue for November and December and it's not currently a big issue. Looking ahead into January and February, it's really not a big issue, perhaps even a small issue from seasonal furniture and some other types of items like that and talking to the merchants, not big delays but a little bit of a backup.

In terms of CapEx, first quarter '15, we spent $555 million. Our fiscal '15 CapEx is estimated to be in the $2.5 billion plus range. This compares to last year's $2 billion. So, up pretty significantly year-over-year with our ramp up and expansion. All the complementary things that go along with that, with depot expansion, and of course, the IT expenses that I had just mentioned as well.

In terms of dividends, our quarterly dividend of 0.355 a share or $1.42 annualized. Based on shares outstanding is about $625 million annually. We did buy a little stock back in Q1 about $18 million at an average price of $126.43. And the first, I believe, five weeks of this quarter we were under blackout from the prior year with -- until we were able to report first quarter and so we didn't buy heck of a lot during the quarter.

Costco Online, we're now in four countries, U.S., Canada, U.K. and Mexico. For the quarter, sales and profit were up over the year. E-commerce sales were up 20%, up 19% on a comp basis and up 21% excluding FX. A rep stores represents about 3% of our total sales, just under 3%.

We continue to -- from really going back couple of years ago, where we platform decide, we've gone through a couple of iterations of improving our mobile applications as I think I mentioned earlier. We've combined some of our e-commerce merchandise efforts with our inline efforts. We think that's been a big help to us. We've added a few categories like apparel, health and beauty aids and few extra Kirkland signature items. We've certainly improved timing of shipments by shipping what we ship directly instead of from the manufacturer from one depot to a few depots around the country. Our international markets, stay tuned, maybe one additional country by fiscal year end '15, certainly lease one by the end of calendar '15.

In terms of a few other things that we talked about in the past, Google Shopping experience -- Express is now being offered in six markets in the U.S. Bay Area, which is recent -- now geographically expanded from its initial testing 10 months ago.

The Los Angeles area, New York City, Manhattan and more recently in October, the test continued into three new cities, Chicago, DC and Boston. Again, it's too early to completely tell but we're seeing some increased overall spend and it’s been a good partner to work with Google. We continue to increase our offerings and categories in these tests as well.

Instacart, it’s now in 13 markets. This is where customer in this cart order through its cart. They come in and buy merchandise and deliver it to the customer. That’s needed to expand as well and boxed as now in three markets, I think, up from two.

Lastly, I think you saw the release, maybe we talked about it with Ali Baba team all in being shipped out of our Taiwan operations. We’re shipping -- I think we’re up to about 125, 130 items, mostly various food or sundries or harbor related items, about half our [indiscernible] Signature. It's great but it's new and we’ll see where it goes from here but certainly get our name noted a little bit over there as well.

In terms of expansion, as I mentioned, we’ve got a lot going -- nothing going on in Q2, just a few in Q3. We have five openings, although two of them are relocation. So, net of three. And we’ve got 20 plan for the 16-week fourth quarter. Most of those look pretty good at this point. It’s just how they -- the timing of them.

In fiscal ‘14, for all the fiscal ‘14, which ended of course at the end of August, we added 29 units or about 5% unit square footage growth. In ‘15, assuming we add the 30 to 31 units on a base of 663, we would -- that would also be about 5% square footage growth.

If we get to 31, it will be 18 in the U.S., three each in Japan and Mexico, two each in Australia and Korea and one each in Canada, U.K. and Taiwan. So U.S. for square footage numbers at Q1 end total square footage stood at 96,437,000 square feet.

With that, I’m going to turn it back over to Erica for any questions. Thank you.

Question-and-Answer Session

Operator

[Operator Instructions] Your first question comes from line of John Heinbockel with Guggenheim Securities.

John Heinbockel

So Rich, I want to drill on a little bit on growth by category. So two were up, two were down, the two that were down are some fresh food and hard line. Fresh food was solely passthrough of inflation and was hard line's entirely mix?

Richard Galanti

Fresh food was certainly inflation in U.S. holding prices, like you know, we do. Things I know again soundbite anecdotal. Butter and milk is way up and so -- therefore cheese. And so you've got those types of items. On the other side, some of it's electronics, that's more competitive and we're part of that. And so a little of it is mix but ….

John Heinbockel

Yeah.

Richard Galanti

…in our view, nothing really has the ordinary.

John Heinbockel

And then when you look at the two that were up and I think they were not up a lot, is that solely mix and where is Kirkland, I guess, Kirkland would have the big impact in food and sundries. That's what would show up. Is that primarily driving the better mix?

Richard Galanti

Honestly, I don't have that level of detail in front of me. I'm looking -- first of all, none of the ups or downs were -- they were in the 10 to 25 basis point range, basically up or down. So not a lot of jumping either way. So my guess is a little of its mix. KS helps but clearly KS, the big penetration increase of KS from 0 to 25% over the last high teens are 20 years. Those increments are smaller now. And so -- yes, it helps but it doesn't help like the days when you're adding a percentage point or two in a year sometimes.

John Heinbockel

All right. Then, lastly on -- you talked about FX and inventory, even putting that aside, obviously inventory is under awfully good control, is that -- is more of that in-store or is more of that sort of backstage between your vendor in the stores?

Richard Galanti

Keep in mind, if we are turning our inventories 12 plus times a year, everything is pretty fast paced. If you are in Canada or Japan or wherever, and you're buying -- buyers using FX contracts because they've got, in most cases, U.S. dollar denominated inventory payables. They are going to lock-in based on what they got coming in, what they know if they are going to have pay out in dollars. And at time when they are comfortable with -- based on that conversion rate, they are comfortable with the price where they are going to sell in their local currency in their local country.

So it's pretty straightforward. In fairness, as you know, it's some quarters year-over-year, some quarters it's a $10 million gain, some times it's $10 million loss. This time, it was a little better. I think partly a reflection of the weakness and the strength in the dollar, how quickly that's strengthened it, particularly in a couple of countries.

John Heinbockel

It's nothing you are doing structurally -- although there is nothing you are doing structurally to take inventory working capital out of the system?

Richard Galanti

No. I mean, we do that -- I mean, that's just kind of one of the mantras that we try to do anyway. Mind you, I mean, this is an example from gosh, 20 years ago in the tobacco business which is a very high volume, not as high one is used to be but a very high volume business, a very fast turning business. A number of years ago, the big -- the majors offered -- let's say whatever the terms were, x percent discount, if paid within seven days. And then they came back and said, we'll give you an extra half a point, if you pay one day EFT or ACH or whatever, it was. So 0.5% for paying six days early.

It's no brainer, but you take a high volume item like that. And it goes from a lot of -- probably 100% payable to 0 almost. So I mean, that's an extreme example. You've got gas working the other way where accounts payable is probably 600% or 700%.

John Heinbockel

Okay. Thank you.

Operator

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

Joshua Siber

Good morning. This is Joshua Siber on for Simon Gutman. Just curious looking back how our customers reacting to lower gasoline prices and have you seen any trade up from regular to premium?

Richard Galanti

I don't know -- I think we saw more premium anyway but I don't know that at the top of my head. I think the reflection that our shopping frequency in our concept continues strong. It is probably a reflection of that. Our view historically has been on something big like this whether it was -- gas was going crazy upward towards $4 a gallon in early to mid ‘08. Did it impact us? It probably impacts a little bit but not as much as some of the dollar type stores or lower demographic stores. We -- similarly, we get a little benefit from it, yes but we don’t think it's big either way for us.

Joshua Siber

Okay, so….

Richard Galanti

It’s got to be helpful.

Joshua Siber

Sorry, what was that?

Richard Galanti

It’s got to help a little.

Joshua Siber

Okay. And then looking forward, if gasoline stays where it’s at right now, is there a change in profitability or have we seen the most of it in Q1?

Richard Galanti

Well, I’ll say what I know. I mean, this is a volatile business as we know. Generally speaking, when it’s declining, it’s the best in terms of profitability. It is more profitable at any level than it used to be a little bit. I think a part of that and again, we -- so it’s a profitable business. It's a lower percent of sales, profitability than the company as a whole.

I think one thing that’s encouraging for us though is, it’s more and more people coming to get their gas. For those that come in this, we’ve heard a people that shop -- that pump gas during opening hours, a little over 50 of them now come in and shop. And so even if one or two of those 50 are incremental, that's a positive.

We've been helped two years in a row now with these outside entities like gasplay.com where nationwide on average, we are the lowest priced. That's helped. I know, our gallon comps in the first quarter were low single digits, which is really off the charge in terms of getting people into our parking lot, that's good.

Joshua Siber

Okay. Again, if you don't mind, if I could add just one more, if you could discuss, has there been a mentality or strategic shift on e-commerce front. If you feel you've gotten more aggressive over the past 6 to 12 months?

Richard Galanti

I think the things that I mentioned is probably been over the past 6 to 18 or 24 month but certainly we -- we've added a few SKUs, expanded some categories, trying to get people to think of it, not just as the place that I can buy patio furniture or big TV but also some regular higher velocity items.

And yes, nothing, I think has been more, if you look -- if I just looked at year-over-year sales increases on a comp basis, it wasn't a couple of years ago. It was kind of in the mid-single -- stuck in the mid single digits and last year, it was in the high teens and this quarter, it continues in that very high teen, low 20. So I think that's a reflection of the things that we've done but nothing new and dramatic in the last six months continuation of that.

Joshua Siber

Okay. Thank you very much.

Operator

Your next question comes from the line of Charles Grom with Sterne, Agee.

Charles Grom

Good morning, Richard. Just to clarify on the gross margin grade, did you say that x gas, the quarter was down 13 basis points?

Richard Galanti

The quarter is down but again, it's also like -- it's under the phrase, no good deed goes unpunished as over the years as I've tried to explain this in a little matrix. You almost need a three-dimensional matrix given the gas was strong and gas gross margins were very strong relative to the very low gross margin business. That disproportionately rates those two lines in that little matrix such that -- and that's why I pointed out if you could adjust food and sundries, hard lines, soft lines and fresh foods, those four core areas, which, gosh, are better 80 plus percent of our business. Those were year-over-year were down two basis points, two of those sub departments up, 10 to 25 basis points, two of them down 10 to 25 basis points. So the core business is pretty much flat year-over-year. But it shows in that chart that way because they had higher dollar penetration of gas.

Charles Grom

Okay. So the up two basis points were more or less compared to, say, that up six or seven basis points that you posted in the third and fourth quarter?

Richard Galanti

Yeah. But it was down two and not upside.

Charles Grom

I'm sorry, down 2. Yeah, okay. Okay, I got it. And then on a CapEx guidance, you had a big acceleration from this year versus last year, yet store growth was pretty consistent. Just wondering if you could speak to the delta, is it IT spend, is it land or just what's driving the increase?

Richard Galanti

Well. It's also former locations including relos. I think it's probably at least a 100 of it. International was more expensive. We probably are spending more this year on depot type stuff. All I'm rounding here but depots, I bet year-over-year is 100, 150 higher. So it's probably -- but year-over-year in the prior year, there was probably 75 to 100 in IT and excluding from the leap year. But the big things are in.

Certainly for the year, that 25 to 26 number, we have an original budget probably a little higher than that. But we know that a couple of them flip and so that assumes land baking for the first part of next year. But clearly we are spending more on some of these international locations in a confident way frankly. I mean, some of the ones in Asia as you know not coming with so far have been relatively no-brainers.

Charles Grom

Okay. Just last question on the balance sheet. Roughly, $70 per share in cash, any updated thoughts on and getting a little bit more systematic on the buyback from doing so much each quarter, so much each year as opposed to setting up the grid and any thoughts on the current dividend 1% yield is lot lower than some of your consumer stable peers?

Richard Galanti

Yeah. Our Board discusses it in every quarterly Board Meeting. Again, I guess I learned that the metrics works when stocks move slowly in either direction. We have had that high-quality problem that we put the makers in place and then in some cases, we are locked in for five or six weeks due to blackout, and then it moves well above several dollars of accretion we gave it.

I think we want to be more systematic, but I can't say when it will be. We will talk to you next quarter but certainly, given that we grant to these 40, 200 or 300 employees annual grants that are just in the high threes, the 3.8 million shares or something. We want to at least come to that, I think on an ongoing basis and we certainly did not do that on a quarterly basis this quarter. But the year is still young and we will see. We will let you know next quarter.

Charles Grom

All right. Thanks a lot. Good luck.

Richard Galanti

As it relates to the dividend, again, that's the conversation we continue to have and we look at all. And we recognize that as first priority is CapEx and then tied for second, if you will or few other things that we'll continue to look at. I'm sure we will just do things over time but beyond a timetable that we feel comfortable.

Charles Grom

Thank you.

Operator

Your next question comes from the line of Brian Nagel with Oppenheimer.

Brian Nagel

Hi. Good morning. Nice quarter. A couple of questions. I mean, first off on gross margins. If you look at that, you may have discussed in the prepared remarks, I apologize. But the ancillary gross margin benefit you saw in, beginning here in Q1, can you just discussed the drivers of that and how should we think about coming to sustainability of that over the next two quarters?

Richard Galanti

Well, I mean, the bigger hurdle was gas. As I mentioned, I think five or six, or five or seven, or six or seven of our ancillary businesses all had up year-over-year gross margins. Most particularly was gas. And so is that sustainable? No. It’s never sustainable. You see where gas prices are now, so it's continuing. But again that could be fleeting and we have been asked the question. Well, when you get these outsized profits, are you more aggressive in pricing? We don’t sit down and say let's use this many dollars but certainly we are going to be aggressive and that’s what we do for living. So, I think that buffers a little bit as well.

Brian Nagel

It’s actually goes in my next question. I think, Richard, you already answered it. In the marketplace, if we look at Costco gas right now, I know from a competitive standpoint Costco gas versus competitors, you typically price below. You are saying that -- when prices are doing what they’ve done, you essentially kept the competitive relationship the same in various markets.

Richard Galanti

We’ve improved the competitive relationship in our minds.

Brian Nagel

Okay. All right. Thank you.

Operator

Your next question comes from the line of Dan Binder with Jefferies.

Dan Binder

Hi. It’s Dan Binder. Congrats on a good quarter. Just want to follow-up on the gas discussion, with all the movement in the gallon comps and the pricing, where are we now as a percentage of sales for gas?

Richard Galanti

I’ll have somebody calculate it right now for you. Hold on a second.

Dan Binder

Okay. My other question, if you want to focus on that, first, is on consumer electronics. You talked to a lot of strength there. Any color you can give us around, sort of the breadth of that strength, where you are seeing it, what you are seeing with 4K TV and competitive pricing?

Richard Galanti

First of all, as you know, we introduced several Apple products over the last year. That's a very competitive business for retailers and for us as well. We know that. But we won't have that product for our members. 4K TVs are going well. I believe that on those higher end TVs, we tend to be the outlier in terms of driving sales of those. But it is still small relative to the entire category of that component.

Phone business is very strong. You've seen what we've done with our kiosks out there and not only phone businesses have been strong, added to that, we've added the Apple brand there as well. And then the various tablets. So there's a lot of different things in that area that are helping the sales strength. Again, I think it tends to be a little more competitive. Apple is part of that. That's pretty much it. Nothing out of the ordinary, I mean, these things fluctuate up and down a little bit. We are pleased of the strength of the comps in that area.

Dan Binder

And then…

Richard Galanti

By the way, in terms of the question about gas penetration, for the quarter it was about 10.5%.

Dan Binder

10.5%. And just a quick question on the cannibalization rate. I know it hasn't really changed much. I think it was like 50 basis points in any given month on the comp. I was just curious. Can you give us an idea of what you're seeing on the bounce back of those clubs once you cannibalize it? Does it come back to sort of historical volumes within year, two years, has that been changing at all as you've been doing more fill-ins?

Richard Galanti

Generally, it's a year or maybe slightly over a year. I mean, generally when we open it, when we cannibalize our own units, you might take anywhere as much as 10% or 15% from nearby unit or units. And a year, a year and a half later you are pretty much back. Going forward, not looking back the past year of course. And again, it varies but overall it's been pretty unpredictable for us. Based on zip code analysis and where the members are shopping from, we generally know.

And what we find is the benefit really is, when we pick up a few extra members yes, not a lot where we pick up a lot of frequency. If you have a loyal member that's shopping and making these numbers up once a month because they are a 30 minute drive away from a Costco and all of a sudden, they are 10 minute driveway and it becomes a significantly more regular shopping frequency.

Dan Binder

Great. Thanks.

Operator

Your next question comes from the line of Meredith Adler with Barclays.

Meredith Adler

It's Meredith Adler. I was wondering -- I'm still somewhat new to the Costco story. If you could talk about where you see the most potential growth? Obviously, you don't have a lot of locations in Continental Europe and yet it's tough to get open warehouses there. When you look at Asia, do you feel like you've still got a lot more growth in those markets and what about the U.S.?

Richard Galanti

Well, if you had asked me five years ago, where we would expect to be now, I would say our goal is to get up to about 30 locations a year by this time and probably, we be right to that middle point of trending from majority in the U.S. to less than half in the U.S. If you look at this year next, it's 30 -- roughly 30 a year, still a little over half in the U.S. I think 16 or so last year and I think I mentioned 18 out of 31 this year.

So, that's by the way a function that we've continued to be successful and while we will still get another unit opened in the Puget Sound or perhaps in the Portland area one day or hopefully, every year or two, we get another LA unit in the Greater LA market of 45 or 50 units. But their precision points now where locations where we need to go.

But we are finding in a lot of these cities and markets like Baton Rouge, New Orleans last year. So that's probably upped our expectation a little bit about our opportunities here in the U.S. Outside of the U.S., we've got 10 or 11, I believe in each of Korea and Taiwan, maybe 12. And we think that we can go into the mid-to-high 20s there over time. But, again, it takes some time to get done and where.

Japan is certainly a bigger market for us. We've got 23, I believe, 22 or 23. We should have a lot more than that. But we went from 9 to 21 or something in little over two years. So we are doing well there. And we just -- as I mentioned, opened our seventh in Australia. While Australia is what two-thirds of the size population wise as Canada, where we have 90 or so units, we have seven in Australia. I'm not suggesting we are going to have 45 in Australia anytime soon. But certainly we will get more than seven.

Western Europe, all of Europe is certainly an opportunity for us. It is tough to get in even in the worst of economies where we have been successful with about four years of effort getting one unit opened in Spain, with the second coming towards the middle to the end of next calendar year. And we still finally get our first unit opened in France. So it takes some time but we are persistent and we will be around.

Meredith Adler

Okay. Great. Thank you very much.

Operator

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

Mark Miller

Hi. Good morning. A slightly different question on gas prices and my historical recollection is that when gas prices were high, more consumers might go out of their way to drive to Costco and then that was viewed as a historical benefit to traffic. But the inverse does not appear to be happening and so I'm wondering what in your view has changed or I mean, do you think there is a risk of gas prices stay lower that you may not get quite as much a lift in terms of traffic to the stores as in the past?

Richard Galanti

You are skyrocketing back in '08, going up towards $4 for the first time. We are on news every night somewhere, whether it's a small-town in Montana or Los Angeles and where is the best place for my guests. So that's certainly was a positive. Theoretically, oil amazes the people, as prices fall, that will be less of an incentive. I think it's a greater -- that membership value proposition. When a gas play.com comes ounces $40 plus million inputs from customer, from drivers out there saying that we are the best lowest price nationally by $0.14 or $0.16 that resonates. The fresh foods, second to none in our view were biased but that drives a lot of business.

The pharmacy, frankly, I think deserved credit. We get through that in terms of pricing. So the fact that we -- we are proud of fact that we take care of our employees. All those things are positives. I think once you've come to Costco for gas and we got you into the warehouse, there is reasons why you are going to come back. And I think we're starting to appreciate the fact that it is all of the above. It's some of the crazy KS items that are KS items where you've got the money, you got to buy them at Costco. Although there are few other places now you can buy them, but we are selling into those people.

Mark Miller

Your traffic just continues to amaze. My other question is on China and so, I understand it's very early with Alibaba. But I want to ask is there any change in your long-term thinking on China? You did say that there is a benefit of getting your name known there. I mean, historically, you've had some reservations but are you -- should we be thinking that comp growth is in the future there and what might inform that? Thanks.

Richard Galanti

Yeah. I think it's in the future. But if you had asked me that same question 10 years ago, I would say I think it's in the future. And not being acute about it, every couple three years, Senior Management, both international Senior Management and it is a giant market. We are confident about what we do. We are also very hands-on and we got a lot of things going on in a lot of directions and we kind of know. We know that the anticipation is somebody is getting their first. Well, people go out in other places first and when we will come in, we will do just fine. So it will be at some point. I don't know when, if you said -- in most likelihood in the next 5 to 10 years, sure. Next two to five years, maybe. Next Thursday, we are not ready yet.

Mark Miller

Okay. All right. Thanks Richard.

Operator

Your next question comes from the line of Chris Horvers with J.P. Morgan.

Chris Horvers

Thanks. Good morning. So, I want to follow-up on the acceleration in the core comps over the past year. It seems like most of the acceleration is seen in the hardlines category. So would you agree with that, or has there been movements toward the high-end of the ranges that you provide in softlines and fresh foods and so forth? And within CE, is that TV turning positive, plus the addition of Apple driving the hardlines rebound?

Richard Galanti

Well, that's one of the things I think I mentioned. Tires have been good this year. Automotive, lawn and garden have been good and we have season for that now. Apparel has continued to be strong and we enjoyed a couple of years on a compounded basis. Apparel comps saw increases in the mid-to-high teens. So that of course at some point has got to come down a little bit, but the organic is helping. I think in the last two years, we've little more than doubled organic sales from the low billions to closing in on $3 billion currently. And so that’s -- all those things help.

Chris Horvers

So within the hardlines category, is that TV and Apples, essentially that’s driven that acceleration within the major sort of…?

Richard Galanti

I will say TV and Apple are probably the top two without looking at the detail. Phones are probably in there too. Phone could be first or second for us. I mean, phones are first but phones, TV and the reintroduction of some of the Apple items.

Chris Horvers

And when you didn't sell, let’s say iPads, were you selling iPhones in the wireless kiosks?

Richard Galanti

Yes.

Chris Horvers

Okay.

Richard Galanti

We are. By the way as comment was made here in my office, those are the big volume categories. But white goods are up. Now that we do a big white goods business, audio is up. Again, smaller business but we -- and that’s not just headphones, it’s the sound systems and all kinds of stuff. But the big volume areas are those three that I mentioned.

Chris Horvers

And was Apple sort of a point in time add back to the store base overall? Or did that start in let’s say June and then ramp up over the past five months?

Richard Galanti

I think that's right. But it's a piece of it. It’s not the driving piece.

Chris Horvers

Understood. Understood. Yeah. And then on depreciation, can you give us some color how to think about the depreciation? I know you -- I don’t believe you historically guide to it, but with the incremental CapEx over the past couple years it would seem like dollars per week or dollars per quarter that will continue to arise for, I think the next couple years and so any color there?

Richard Galanti

Yeah. I hope it continues to rise forever. Probably, the simplest way to do it is look at what is done for each of the last several years, year-over-year in dollars. My guess it’s somewhere around 10%ish and that's probably as good a guess. Maybe, if you want to add a little bit to it for IT modernization, as you know, over four or five-year period on an incremental basis, we’re probably spending close to $0.5 billion, that generally once these different modules and components are put into operation, they then to get amortized over five to seven years and so maybe that adds a little bit to that $1 billion plus number.

Chris Horvers

And then where does that depreciation tend to show up in terms of the margin bucket? I know you talked about central, but is that core as well?

Richard Galanti

It's all SG&A. Virtually, all SG&A.

Chris Horvers

Okay. Understood. Thanks very much, Richard.

Operator

Your next question comes from the line of Bob Drbul with Nomura Securities.

Kevin Heenan

Hi. This is Kevin Heenan on for Bob Drbul. You had called out apparel as being strong within softlines. I was just wondering if there were any particular categories of brands within apparel that were particularly strong in the quarter.

Richard Galanti

It’s really all of the above. I mean, we have made a conscious -- over the last couple of years, a conscious effort to both, with brands and with

Kirkland Signature, go bigger and deeper, mashing out big quantities in the stuff. And so it really is all over the board, names that you've come to know like Dockers and Levi's and Carhartt and just a variety of ones. But also the KS, whether its women's activewear or what was -- the men's wear pant, certainly the five plus million KS shirts and men's dress shirts that we sell a year. So it's a lot of things.

Kevin Heenan

Cool. Thanks. And then just my last question. We noticed you guys have handheld scanners now in store. As you are checking out, we're wondering, kind of how that test was going, understanding information around that?

Richard Galanti

Yeah. Well, I think the handheld scanner -- well, there is two things that we used in handheld scanner. We give some level of autonomy to the operators on that. Some regions embraced it little more than others. Generally, what we find and I say there is two uses. One use is your clients are backing up and employee was one of those handheld scanners could go and essentially scan.

It was a small basket. And you will say, if its top fold and you have things under other things, you can't do it. But they can help speed up the front-end by scanning -- in the case of a limited number of items, those items give that member a little print out with the barcode on it. When the member gets up to the cash register, the cashier can simply scan that barcode. It prints out and tenders that full transaction was all the detail. That's one way speeding up.

The other thing, its use for is in terms of informing people, when it would make sense for them to convert from a regular member to the Executive Member based on their prior 12 months of purchases. So if lines are backed up a little bit and we can ask the member, if we can scan their card and we can let them know that based on their prior years purchases, they were paid as example in the U.S. of an extra $55 when $10 versus $55 and they would've earned well more than that. And so it’s use for that, but we don't do that all the time because as we've increased shopping frequency, the member who said no doesn’t want to have to say no. I mean, we cannot have. So we did that on a periodic basis.

Kevin Heenan

Got you. All right. Thanks a lot for the information.

Operator

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

Oliver Chen

Thanks. Congrats on the performance and thanks for the details. Regarding a bigger picture question on online, where do you think the mix should go over time? Will it remain a little bit more modest as a percentage of total? And as you look at your guest and the customers like, which factors do people want to see you guys implement over time? And I just wanted to ask about food and protein and fresh food, what’s your outlook for the inflation there? And will your pricing under price the inflation and how do you see that dynamic evolving?

Richard Galanti

Let’s start with the last question. I mean, our fresh foods people use some continuation on prices like cheese and milk and butter. A lot of that has to do with some shortages in China and so increased demand from China that has pushed that out a little bit. There is still some inflation in meat. I believe, you said that that pork expectation was coming back a little bit and cheese is finally coming down a little bit.

So the expectation is yes, but not probably as severe like meat have been up 8% to 10% in prices. They will expect that level of additional inflation going forward but still some. In terms of pricing, generally, we're going to try to take price increases as early as possible and take price decreases as soon as possible. So if using the famous rotisserie chicken example, we maintain the price, while costs were going up for two years, we didn't -- when the input costs starts going down, we didn't change the price because we've never raised it. But overall, we're going to lag a little bit because we won't be competitive.

And getting back to the first question was on Costco.com and mix changes. Yeah, it should continue to inch up more towards. When we started it, it was all big ticket. In many cases hard to take home yourself or hard to install, or hard to put together items, whether its big-screen TVs or furniture or swingsets, you name it.

We certainly wanted to be more than just that and I think again, we've seen some success there, so we keep trying things. What we don't see ourselves is being the entity that's going to deliver two different boxes of kid cereals to your doorstep at seven in the morning. Now we hope and look forward to some of these other entities that are doing those types of quick home deliveries for us to be their supplier, which we seem to be successful doing as well. But overall, we want our site to be thought about a more regular basis as well for our members.

Oliver Chen

Okay.

Richard Galanti

And some of those are health and beauty aid items. Some of those are sundries items will certainly help to close that too.

Oliver Chen

And I've used the mobile app. Do you feel like the mobile app is going to be a key part of traffic online for you as it evolves?

Richard Galanti

It will. It’s continuing and when we look at our - when Ginnie Roeglin represents each month in the budget meeting about Costco.com, we have higher and higher percentages of mobile app use. Not as nearly as much as some of the e-commerce entities out there but it’s going in that direction. So, yeah, we’ll keep getting better. Like everything at Costco, while our site is greatly improved from the original mobile apps that we did, there is room for improvement there and we know that.

Oliver Chen

Okay. Thank you. And a last question. On the higher end strength, have you seen customer response in a very positive to higher price points or your assortment, as we see healthier high-end customers as well as your product assortment being very appealing?

Richard Galanti

Well, that’s what we’ve done. That’s what we do. I mean, since the beginning of time, we’ve constantly try to trade customers up to better quality. We’re still a merchant. We just want to sell a lot of stuff and higher-end stuff. And frankly, we can show great savings from that. If you go into our warehouses right now, it is partly for the holiday time and I’ve seen some $3,000 and $5,000 and $7,000 wine and spirits pricing, which are great values at those price points.

Certainly, our jewelry are higher end. Certainly, the fact that we do a great penetration in the bigger sized televisions, so that’s something. Anecdotally, I remember also, at the end of calendar ‘08 and then to calendar ‘09, when economy went south fast. And I remember and of course, at the end of ‘08 and then to early ’09, when we took some extraordinary markdowns on things like patio furniture in January, February because the economy just hitting people, weren’t buying that much those big-ticket discretionary items.

I remember, as we entered June, July as the buyers are getting ready to commit for the upcoming end of '09 into 2010 season, our CEO, Jim, at the time and our Head of Merchandising were reminding the buyers, don't start bringing the price points down. If you want to come back for a little volume, quantity fine, but let's -- we've traded our members up and our members expect higher end goods. Let's keep that going, because that's what we are -- that what helps us, one of the things that helps a standout in our view.

Oliver Chen

Thanks. Thanks for the comments on the luxury goods and that experience. Best regards for the holidays.

Richard Galanti

Thank you.

Operator

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

Matt Fassler

Thanks a lot. Good morning. It's Matt Fassler. Thanks for keep the call going here. My one question at this stage relates to IT modernization. Richard, if you could just talk about qualitatively, what you've gotten done and what is still on the common? And then how you would expect those additional investments to further enable the online in e-commerce effort? Thank you.

Richard Galanti

Well, first of all, for those of you who have noticed for long time, it's going to keep us alive and growing. I mean, our view is as that, we were at the top of our game in terms of keeping systems, old legacy systems as long and as cheaply as possible. And the recognition is that we did have to modernize, we knew that and we started that really in earnest about two, two and a half years ago, getting ready to start that process.

So, and our goal, of course, is to take us over the next 10 years to double our company and I’m not trying to -- we don’t have 10-year budgets, but certainly, at a reasonable growth factor that should be what we want to do. We need systems to do that particularly as we going to other countries and expand in existing smaller countries right now that we’re in, smaller number of units and as we global source more.

So, all those things are imperative and as you know, we've done very little historically with member data. Don't expect big things from us, but expect any little things still low-hanging food for us. So we’ll be able to do a little more that.

First order of business to get it done, what is being installed so far, we’ve redone the front-end membership system. Right now, if you want to change your address or phone number, you have two ways to do it. You call at 800 number or you go by the membership desk.

Well, if a million or 2 million if you do something every year, its one time each for 2 many people, it’s 2 million times for us. So some simple things like that will start early next year, early to mid next year. But there's certainly lot more to do with that stuff, even some basics.

We also redid the point-of-sale system and that’s in, that’s making -- and when I say that’s in, it’s just in. For the two months -- the last two months of calendar year, we have an unwritten or written rule, you can't -- don’t do anything, just grow up the systems and the warehouse.

And so, while we've now installed it in the number of locations and its will be on pilot and our operators want it and like it, and then it will say, scheduling and few other things, that will be into earnest until during half of calendar ’15.

There is one other thing, the payroll. We just redid the payroll system and that's pretty U.S only to start with, which is 70% of our company. And that's again something that's making life a little easier in the warehouses and there is some small benefits to that there.

The big benefits are when we complete the things that you got to put these things including accounting systems in place first. Our accounting systems are planned to be installed as of this fiscal year end, so at the end of this August, fingers crossed, that will be the best time to do with it, the fiscal year end and currently, we're on test, but we will tell you more, how we are on test tomorrow.

The -- beyond that, I mean, the big things that the users are excited about, if we look at our depot and truck fleet operation, there is some real savings and efficiencies in our depot operations that their aches to get in place, that still going to be six to 12 -- six to, I will say, six to 18 months out, because these are all overlapped -- these modules overlap each other somewhat.

The challenges going to be as we -- as buyers who are use to doing things one way, have to do things little different. We learned a lot of lessons when we went to Spain. We started with basically the new SAP-oriented system and there, as you might expect there are few Costco people over there. We've learned a lot, including pain in the behind things.

So, I think that, we know what the expenses are and we know incrementally, we still got another year, year and half for that, by its own size it will -- then will have level off. Again, I think, looking two to five years out is when we're going to -- we have got to get over that hump and there will be, I am sure, some growing pains where we make those conversions. But we've gotten a lot better of not just doing something and then letting everybody all the users figured out.

We're using 10s and 20s and 30s of additions of people to certain departments focus entire, taking existing people to know us, our current systems and putting them on these SAP modernization projects. And so, we’ve done a much better job of bringing good people in and committing to two or three years in some cases those people in that area.

Matt Fassler

Thank you so much.

Richard Galanti

So we’ll continue.

Matt Fassler

Great. Thank you.

Operator

Your next question comes from line of Chuck Cerankosky with Northcoast Research.

Chuck Cerankosky

Good morning, everyone. Richard, you may have said it, but I’ll double check on this regarding the gas. What was the year-over-year decrease in the gas price and can you talk about gas gallons on a comp basis increase?

Richard Galanti

The average price per gallon was down 7.3% and the comps were -- the gallons comps were I think 11%, I know it was a low double-digit, 10.5%.

Chuck Cerankosky

Okay. 10.5.

Richard Galanti

Yeah.

Chuck Cerankosky

Okay. Thank you. And I'm curious about the buying or having merchandise shift ahead of -- a little bit ahead of sales plan because of some of these slowdowns on -- in the ports? Where is the extra merchandise being stored? Is it in the clubs or is that in your depots, or even offsite?

Richard Galanti

Well, Costco, yeah, no, it's not offsite. It's mostly in depots or the clubs. I mean we were stacked tall, but we turned it pretty fast too. It wasn't a huge issue, it was -- it wasn't issue, but it -- in terms of logistics of handling it. But basically the depots had little bit more for a few weeks.

Chuck Cerankosky

Okay. So if it is selling it's there…

Richard Galanti

Yeah.

Chuck Cerankosky

… just gets it there ahead of time.

Richard Galanti

All right. Thanks.

Operator

Your next question comes from line of Scott Mushkin with Wolfe Research.

Mike Otway

Hey. Good morning, guys. This is Mike Otway in for Scott. Thanks for taking the questions. I think, first, Richard, you had said that outside of pharmacy that all the other ancillary businesses and their gross margin rates up in the quarter? So, I guess, outside of gas, which is obviously, transitory? How should we think about your ability to get some slight margin improvement on these other businesses over the course of the year?

Richard Galanti

The ancillary, well, most of them were up year-over-year. I mean, a lot of it’s -- it’s particularly in some of the business like Optometry and Hearing Aid. I mean they -- the actual markup on the goods is higher than our range, because we included our own cost of sales calculation, the impact of the Hearing Aid tax or of the Optometrist and things like that. So it's -- but it's a when volume is driven its operating leverage is certainly in my view better than their warehouse as a whole.

So more than anything, I mean, we keep looking to, as you've heard it before, bring prices down. Over the last couple of years when we introduced, I forget what the, it’s 5.0 or 6.0, whatever the next level of the state-of-the-art Hearing Aids under our brand. We lowered the price point by close to $2,000 on by -- on a high-quality Kirkland Signature item made by well-known high-end people and we really drove that business. So we save the customer, we’ve made fewer gross margin dollars, but a lot more units, fewer dollars per unit, but a lot more units

Mike Otway

Okay. That’s helpful. Thank you. And then, I guess, just switching gears on the international side, you guys obviously continue to fare pretty well, given the headwinds? But just kind of looking at profitability of the other international business outside of Canada and stepping back, over the last few years, you saw EBIT margins come down slightly in that portion of the business versus I think in the middle part of last decade they were moving up? What's changed and as you add more stores kind of in this segment internationally outside of Canada? What are your expectations for getting profit to move up slightly every year? And I know some of that is new store driven and everything like that but any thoughts there would be great?

Richard Galanti

Well, I think, Craig, our CEO, has said is look that the goal is to first get to three pretax and we'll go -- see where we go from there. First and foremost, we are going to drive our business. We want to see improved profitability every year. And there's a lots of moving parts and some of these ancillary businesses helped Costco travel. There's a little but it's growing nicely. We've got new people in last couple of years in our business centers, what I'll call the 10-plus year test there too. We have them moving in the right direction. We've got eight of them and little bit of a few more so.

So there's lots of things out there. The global sourcing initiatives does two things. It's generally limited resource commodity type items in some cases. In our view, what sets us apart in terms of quality and value, and that drives other business. So there's, I think we are less looking and saying how can we -- do we want to -- we want to grow -- first and foremost, we want to grow comps. You can take out inflation and every thing else. Can we get comps in that mid-single digit to a little higher? If we can do that than how we get topline sales a little higher and then how do we leverage that.

We'll keep doing what we are doing and we are not as concerned about one quarter or one year being a little less. I know we've gone up and down, but certainly we feel comfortable that we've got things in place to keep driving bottomline hopefully a little better than topline. But there will be fluctuations in that.

Mike Otway

Okay. Great. I appreciate it. Thanks again.

Operator

Your next question comes from the line of Robby Ohmes with Bank of America Merrill Lynch.

Robby Ohmes

Hey Richard, another gas question, I know you, love these. From history or maybe the question being when historically, you've moved into a lower gas price environment, big declines year-over-year at the pumps like we are seeing and could see more of. What do you guys tell the buyers to do then? What categories tend to do better when you're having a pretty dramatically falling gas pump prices? Thanks.

Richard Galanti

I don’t think we are smart enough to sit around and say with this extra profit what we can do. I talked to Doug Shaw, the head of U.S. merchandising the other day. His view was is that we are doing everything we're doing anyway. This helps some. Do we do a little more, sure but -- it gives us a little bit more umbrella but we are going to keep doing it.

Robby Ohmes

All right. Thanks.

Operator

Your next question comes from the line of Greg Melich with Evercore.

Greg Melich

Hi. Thanks. Rich. I thought we had a couple of questions left here but could you update us on inflation across the store both in COGS and at the retail level?

Richard Galanti

Yeah, if you look -- here we go. Basically again a very slight deflation for the first 12 weeks where food and sundries has very slight inflation. Sundries is a very slight inflation like less than 10 basis points. Apparel is very slight inflation also less than 10, right. So that’s really end of our fiscal year. And food, of course, for all of fiscal ‘13 was up about 3.5 percentage points on a cost of goods basis.

But again for the first 12 weeks of this month, it's ever so slightly up. Computers and appliances and things like that are down about a point. Gas, of course, is down as you a little bit. And those are pretty much the pulls and it all adds up to being down less than half percentage point since the beginning of our fiscal year. That's versus being up a 0.5 percentage point all of last year from the beginning of the prior fiscal year.

Greg Melich

That’s helpful and that’s at the COGS levels and same with retail?

Richard Galanti

Yeah.

Greg Melich

Okay.

Richard Galanti

Yeah. I would say the same at retail, if its inflation, maybe its a little thick under that because of our lag but overall it's pretty close.

Greg Melich

Great. And then the second question was I think it was on September, you switched your -- interchanged your card partner in Canada. Could you help us understand how that changes the dynamics either in sales or profits in the business? And also remind us, when your Amex deal expires or when that’s due in the U.S.?

Richard Galanti

Sure. Well, we basically had long-term agreements in Canada and we have one here. We don't really talk about our current contracts. We’ll let you know when and if anything happens. But any ongoing contracts and anything we really don’t talk about. But in Canada, again we made the switch currently for I think about a three-month period ending the end of this month we set both.

So we started accepting MasterCard a couple of months ago. And we'll continue to accept as well American Express in Canada though the end of the calendar year. Look, we would have done it if it wasn't the most attractive deal for us. And remember -- and I would probably reverse the order if this was 10K for our member and us long term because we are going to continue to try the right value.

And so we think it's -- the transition is always a little bit of a hassle, but we worked well with both our former partner and our new partner. Everybody acts professionally in this thing and these things happen. And we have a good relation currently in the U.S. So we'll see where that goes in the future. But as it relates to Canada, I think we're now up to -- and it's not required yet. As of last month, we are in the 30s in terms of the percentage of people using MasterCard, recognizing 40 plus percent of our transactions in Canada before anything else is a debit.

And as you might expect MasterCard has a higher penetration of cardholders in Canada. We want to get that rewards-based card out there. And because infinity programs drive sales, not only in Costco but drive reward-based credit card programs. When we get that member using that card, that co-brand card, the same helped through with American Express co-brand. Will they use it elsewhere, it changes and improves the economics for us, which allows us to again provide a better solution to our member and continue to be more aggressive out there.

Greg Melich

It's helpful. Thanks.

Richard Galanti

It's going as expected, fine and stay tuned in the U.S. what we may or may not do in the future.

Greg Melich

That’s great. Thanks a lot.

Operator

[Operator Instructions] Your next question comes from the line of Joe Feldman with Telsey Advisory Group.

Joe Feldman

Yeah. Hey guys, good morning. Thanks for taking the question. And most have been asked, but I wanted to ask something related to the food side of the business. And I know in the past we've spoken about opportunities within food like new products, maybe organic, natural, more. And I know you've made strides with some of that. But any update on where you stand with organic and natural and how much you could do there?

Richard Galanti

Look I think we can do a lot more. The supply chain is improving and increasing everyday not just for us. Again I think in two years, we've gone to the U.S. from about $1.4 billion to close to $3 billion in organic and that's with supply constraints. So -- our view is there is couple of positives for our view.

One is it's not always a substitute sale. I gave the example and perhaps is an extreme example what for the first 25 million of fresh organic ground beef we did a year and a half or so ago on a multi-hundred million dollar fresh ground beef program. But again $25 million and first 25 million organic, 80% of it was to existing members that historically didn’t buy ground beef from us because they buy organic.

And so that was added sales in that way. The other positive is generally in the retail business. Organic is high -- it was always a higher price point. But it's also generally the higher margin items. This kind of like the sale item you see on white goods is the refrigerator without the icemaker with a small freezer compartment and then you go in, you want the one with all -- the bigger one with all the extra whistles and bells.

Same thing with this, we can generally make a little bit better margin and save the customer more and have a higher price point item. So again its growing. It’s a $3 billion business. I can’t tell you how quickly it will grow, but it's growing certainly faster than our topline overall.

Joe Feldman

Got it. Thank you. And then also wanted to follow-up with the -- you’ve mentioned LivingSocial deal a couple times this quarter, last quarter. Should we expect more on that front or more things like that to come?

Richard Galanti

Well, it's a Catch-22. It worked, recognizing we don’t do a lot of it. But we also don’t want our members to get comfortable waiting -- our people comfortable waiting for the next deal. So we are going to do things on a sporadic basis, on irregular basis. But we at least -- as Craig said to our heads of merchandising e-commerce and membership marketing try some things. And so we are trying some things.

So we are not -- we’ll let you know that the things that we tried generally work. But it's not like we want to change our methodology. We wanted also make sure that the value of the membership is the value of the membership. But we’ll keep trying some things.

Joe Feldman

Got it. Thanks and good luck with this quarter guys.

Richard Galanti

Thank you. Why don’t we take two more questions? And I am sure you guys are tired of listening to me.

Operator

[Operator Instructions] And there are no more audio questions at this time.

Richard Galanti

Well, thank you every one and have a good day.

Operator

Thank you, ladies and gentlemen for joining today’s conference call. This does conclude today’s conference call. You may now disconnect your lines.