HD - Q2 2016 Home Depot Earnings Call
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PRESENTATION

Operator

Good day everyone and welcome to the Home Depot Q2 2016 earnings call. Today's conference is being recorded.

(Operator Instructions)

At this time I'd like to turn the conference over to Ms. Diane Dayhoff, Vice President, Investor Relations. Please go ahead.

Diane Dayhoff - *The Home Depot, Inc. - VP, IR*

Thank you, Sherlon, and good morning to everyone. Joining us on our call today are Craig Menear, Chairman, CEO and President; Ted Decker, EVP of Merchandising; and Carol Tomé, Chief Financial Officer and Executive Vice President, Corporate Services.

Following our prepared remarks, the call will be open for analyst questions. Questions will be limited to analysts and investors and as a reminder we would appreciate it if the participants would limit themselves to one question with one follow-up please. If we are unable to get to your question during the call, please call our investor relations department at 770-384-2387.

Now before four I turn the call over to Craig let me remind you that today's press release and the presentations made by our executives include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These statements are subject to risks and uncertainties that could cause actual results to differ materially from our expectations and projections. These risks and uncertainties include but are not limited to the factors identified in the release and in our filings with the Securities and Exchange Commission.

Today's presentations will also include certain non-GAAP measures. Reconciliation of these measures is provided on our website.

Now let me turn the call over to Craig.

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

Thank you, Diane, and good morning everyone. We had a solid quarter, achieving a milestone of the highest quarterly sales and net earnings results in Company history.

Sales for the second quarter were $26.5 billion, up 6.6% from last year. Comp sales were up 4.7% from last year and our U.S. stores had a positive comp of 5.4%. Diluted earnings per share were $1.97 in the second quarter, up 13.9% versus last year.

In the U.S., all three of our divisions posted positive comps in the second quarter led by our Western division. And all 19 U.S. regions and top 40 markets saw single- to double-digit comps in the quarter.

Internationally, our Mexican and Canadian businesses had another quarter of solid performance. Mexico reported positive double-digit comps in local currency, making it 51 consecutive quarters of positive comps growth. Our Canadian business also posted positive comps in local currency for a total of 19 consecutive quarters of positive comp growth.

We continue to see broad-based growth across our stores, both ticket and transactions grew. All of our merchandising departments posted positive comps and we saw a healthy balance of growth among both our pro and DIY categories with pro sales outpacing our DIY business in the U.S.

The Interline integration is progressing as we continue to deliver on the acquisition's value drivers. We have been piloting our first business use case, offering Interline's catalog of products to pros shopping Home Depot stores. We're pleased with the traction we've seen in this pilot, although it is still early days.

We continue to work towards leveraging Interline's capabilities to expand our share of wallet with our current customers as well as gain new customers. Our online business had sales growth of approximately 19% versus last year and represented 5.6% of total sales. As Ted will detail, we continue to leverage our merchandising tools to refine product offerings across channels based on customer preferences. Our goal is to provide our customers with the convenient and fulfillment options they desire.

We continue to build out capabilities to improve the overall customer experience. For example, in recent months we began implementing our dynamic ETA feature for online purchases. Dynamic ETA provides a delivery date based on the customer's location.

In the past we issued a generic delivery window estimate which allowed for extra time or cushion for the delivery commitment to customers. As we have begun to implement the dynamic ETA our promised delivery date to customers is earlier and more accurately estimated. As a result, we are seeing an increased conversion in customer satisfaction.

We continue to see great productivity from our supply chain as the dividends from investments made over the past several years yield a positive impact on our inventory productivity, logistics costs and service to our stores and customers. As you know, we see our supply chain transformation as an ongoing work in progress and continue to optimize our network with initiatives like supply chain Sync. Sync is in the early stages of a multiyear rollout.

We are investing to more effectively meet our customers' demands. The rollout of COM, our new customer order management system, is now fully deployed in all U.S. stores. The next phase of COM is to optimize and fine-tune this new system. Following behind COM is the rollout of BODFS or Buy Online, Deliver from Store which we expect to be completed by the end of the fiscal year.

While we had a strong quarter, as you have heard we are instituting a high degree of change across many areas of the business. With this amount of change there will be learnings and opportunities to refine the process along the way. In the quarter we identified several opportunities for improvement, particularly around inventory management and freight handling which we're working to address.

Turning to the macro environment, we continue to see positive signs in the housing data which we believe serve as a tailwind for our business. As Carol will detail, we are reaffirming our sales guidance and increasing our earnings per share guidance for the year to reflect our out-performance this quarter and our outlook for the remainder of the year.

A successful spring season depends on the hard work and dedication of the 400,000-plus associates we have serving our customers today. I want to close by thanking them. Based on the first-half results, almost 100% of our stores qualified for Success Sharing, our profit-sharing program for our hourly associates. We are very proud of their efforts.

And with that let me turn the call over to Ted.

Ted Decker - *The Home Depot, Inc. - EVP, Merchandising*

Thanks, Craig, and good morning everyone. We were pleased with our results in the second quarter.

Core maintenance and repair categories as well as many pro heavy categories continued to have solid performance in the quarter. Our growth in the quarter was balanced. Total comp transactions grew by 2.2% for the quarter while comp average ticket increased 2.5%.

Ticket growth was driven by an increase in items per basket as project business continued to show strength. Our average ticket was also positively impacted from slight commodity price inflation, mainly from building materials and lumber. The total impact to ticket growth from commodity price inflation was approximately 18 basis points.

In addition, the stronger U.S. dollar had a negative impact to our average ticket growth of approximately 69 basis points. Focusing on big-ticket sales in the second quarter, transactions for tickets over $900, representing approximately 20% of our U.S. sales, were up 8.1%. The drivers behind the increase in big-ticket purchases were HVAC, appliances and roofing.

All merchandising departments posted positive comps led by appliances which had double-digit comps in the quarter. Tools, lumber, plumbing, decor, indoor garden, building materials and lighting were above the Company's average comp. Hardware, outdoor garden, kitchen and bath, millwork, electrical, paint and flooring were positive but below the Company average.

As Craig mentioned we continue to see notable strength with our pro customers. The pro sales grew faster than the Company comp led by our high spend pro customers. This continued strength led to comps above the Company average in commercial and industrial lighting, fencing, power tools, power tool accessories, wiring devices and interior doors.

We saw continued strength in the core of the store as our customers undertook various projects. For example, landscape lighting, laminate and vinyl flooring, garage organizations and cleaning had strong comps for the quarter. Widespread and record-setting heat in the quarter drove strong performance in HVAC, air-conditioning, fans and air circulation. Sales were also strong in categories like irrigation and watering which delivered double-digit comps.

Our store associates did an exceptional job executing our summer events and creating excitement in our stores. Our Memorial Day, Father's Day and Fourth of July events provided excellent values and we saw strong demand from our customers. These events helped drive robust comps in appliances, tools storage, outdoor power and grills.

In our ongoing effort to update and refresh our assortments, we've continually leveraged our merchandising tools to fine-tune our online and in-store assortments. One specific example of this is with our patio offering. We found that many customers want to come into our stores to purchase and pick up their patio sets.

We altered our assortment and put certain patio sets back into the store. This strategic move was well received by our customers, leading to record sales and sell-through in our stores.

Our online business had strong growth in the quarter with double-digit traffic growth and improvement in conversion. Our interconnected retail initiatives continued to evolve to meet the changing demands of our customers. Mobile and tablet are over 50% of our traffic and are important tools that our customers use to engage with our products, our stores and our associates.

We are enhancing the functionality in mobile with features like larger and clearer product images, live mobile chat and simplified checkout experience. As evidence of the success of our interconnected strategy, approximately 42% off our online orders are now leveraging our store footprint for fulfillment and nearly 90% of our online product returns are processed through the convenience of our stores.

Now let's turn our attention to the third quarter. Our focus on innovation is a key part of our strategy.

For our pro customers we will be introducing the DEWALT FLEXVOLT system in our stores this fall. This DEWALT system uses the innovative FLEXVOLT battery, which identifies various types of DEWALT tools and adjusts voltage to provide the appropriate level of power needed. These products provide corded performance without the cord and the innovative brushless motors increase tool runtime and durability, saving our pros time and money on their jobsites. Among big-box retailers, they DEWALT FLEXVOLT system can only be found at The Home Depot.

As smart devices continue to resonate with customers we are excited about expanding smart technology with the new Ryobi garage door opener. This innovative system connects with any smart device and allows our customers to operate their garage door remotely, talk on the phone or play music through an embedded Bluetooth speaker or park with ease using the laser park assist attachment. The new exclusive Ryobi garage door opener can only be found at The Home Depot.

The fall season and cooler temperatures are just around the corner and we have an incredible lineup of great values and special buys for our customers during our Labor Day, fall cleanup and Halloween harvest events. With the Halloween harvest season we have a tremendous amount of new seasonal products like the exclusive animated window projector kit which allows our customers to easily decorate their windows with animated digital holiday clips. This is the first digital decoration in the marketplace and it is exclusive to The Home Depot.

Our exciting third-quarter events along with outstanding execution in stores will position us for success in the third quarter.

With that I would like to turn the call over to Carol.

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

Thank you, Ted, and hello everyone. Before I review our results I'd like to remind you that our net earnings for the second quarter of 2015 included a pre-tax net expense of $92 million related to our 2014 data breach and a $144 million pre-tax gain on sale of HD Supply common stock. When added together, these two items contributed $0.02 of diluted earnings per share last year that did not repeat this year.

So with that let's get started. In the second quarter, sales were $26.5 billion, a 6.6% increase from last year driven primarily by positive comps sales as well as the impact of Interline Brands. Versus last year, a stronger U.S. dollar negatively impacted total sales growth by approximately $181 million or 0.7%.

Our total Company comps or same-store sales were positive 4.7% for the quarter with positive comps of 2.3% in May, 7.5% in June and 4.5% in July. Comps for U.S. stores were positive 5.4% for the quarter with positive comps of 3% in May, 8.4% in June and 5% in July.

Our monthly comp sales were a bit distorted by the timing of Memorial Day. Last year Memorial Day sales were included in our May results and this you they were included in our June results. Adjusting for this timing shift our U.S. comps would have been 4.3% in May, 7% in June and 5% in July.

Our total Company gross margin was 33.7% for the quarter, an increase of 3 basis points from last year. The change in our gross margin is explained largely by the following factors: first, as expected we had 22 basis points of gross margin contraction due to the impact of Interline; second, we had 13 basis points of gross margin expansion in our supply chain, driven primarily by increased productivity and by lower fuel costs; finally, we had 12 basis points of gross margin expansion due primarily to reaching higher co-op and rebate tiers in certain category classes which lowered our costs.

For fiscal 2016 we continue to expect our gross margin rate to be about the same as what we reported in fiscal 2015. In the second quarter operating expense as a percent of sales decreased by 78 basis points to 18.2%. As I mentioned our expenses in 2015 included $92 million of net data breach related expenses that did not repeat in 2016.

In the quarter we were pleased with our expense performance as total expenses were under our plan. But due to our continued focus on expense control we now believe that our fiscal 2016 expenses will grow at approximately 32% of our fiscal 2016 sales growth rate.

Our operating margin for the quarter was 15.5%, an increase of 81 basis points from last year. Interest and other expense for the second quarter was $228 million, up $144 million from last year reflecting master's pre-tax gain on sale of HD Supply common stock that did not repeat this year.

In the second quarter our effective tax rate was 37% compared to 37.3% in the second quarter of fiscal 2015. For fiscal 2016, we expect our income tax provision rate to be approximately 37%. Our diluted earnings per share for the second quarter were $1.97, an increase of 13.9% from last year.

Now turning to the balance sheet, at the end of the quarter inventory was $12.3 billion, up $464 million from last year due primarily to the impact of Interline. Inventory turns were 5.2 times, up 1/10 from the second quarter of last year. Year over year accounts payable increased by $778 million to $8.3 billion, reflecting the timing of purchases and the impact of Interline.

In the second quarter we repurchased $1.25 billion or approximately 9.46 million shares of outstanding stock. For the remainder of the fiscal year we intend to repurchase approximately $2.5 billion of outstanding stock using excess cash, bringing total anticipated 2016 share repurchases to $5 billion. Computed on the average of beginning and ending long-term debt and equity for the trailing four quarters, return on invested capital was 29%, 400 basis points higher than the second quarter of fiscal 2015.

Now turning our attention to the full year, recent GDP growth estimates suggest a slowdown in the U.S. economy from what we expected. But we are encouraged by the strength of our core business as the U.S. housing market continues to recover. Based on our first-half performance and our outlook for the balance of the year we are reaffirming the sales growth guidance we laid out at the end of our first quarter.

For fiscal 2016 we expect sales to grow by approximately 6.3% with comps of approximately 4.9%. Implied with this guidance is a comp for the second half of fiscal 2016 of approximately 4.3%. This is not a reflection of the sequential slowdown in sales but rather a reflection of year-over-year performance. On a two-year stack basis we expect our comps in the back half of the year to be about the same as what we reported for the first half of the year.

While we are reaffirming our sales growth guidance we are lifting our earnings per share growth guidance for the year, principally because of better expense control and, therefore, more operating leverage than we anticipated at the end of the first quarter. For earnings per share, remember that we guide off of GAAP. We now expect fiscal 2016 diluted earnings per share to grow by approximately 15.6% to $6.31.

So we thank you for your participation in today's call. And, Sherlon, we are now ready for questions.

QUESTION AND ANSWER

Operator

(Operator Instructions) Simeon Gutman, Morgan Stanley.

Simeon Gutman - ***Morgan Stanley - Analyst***

Thanks, good morning. There was a lot of noise it sounds like in the early part of the quarter with weather and some Memorial Day shift.

Was there any, I don't know if it's possible to measure this, but do you think it was some degree of demand destruction that you didn't pick up? Granted June, July improved, but I'm trying to get a sense if you think underlying demand could actually be stronger than it looks?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

I think there's no doubt to your point that May was a tough start. When you look at variability in the quarter month-to-month compared to a year ago we had higher variability and part of that was clearly driven by weather.

An example would be in Washington, DC alone there were 20 days of rain in the month of May. So it's hard to tell but clearly we know there was an impact.

Simeon Gutman - ***Morgan Stanley - Analyst***

Okay. My follow-up, there's a lot of noise in retail across many segments. You mentioned that the housing or housing outlook is fine.

I know this seems obvious but can you maybe just talk about what gives you confidence in it? Is it the pro growth, is it the type of projects? I'm sure it's all the above but I'd love to hear some color on that topic.

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

So clearly when we look at housing, things that we focus on are home value appreciation which continues to grow. We look at housing turnover which is running at norms, a little north of 4% of the housing stock is projected to turn in fiscal 2016. And then we look at new household formations. All of those are drivers in our business and all of those continue to recover.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

But I would say what gives us confidence is strength in the big-ticket. As Ted called out another outstanding quarter in our big-ticket categories. As Ted also called out the growth in the quarter was balanced between ticket and transactions.

And part of the ticket growth was item in the basket growth. And that tells us that the project business is alive and well. And then, finally, we look at the strength in pro and our pro business outpaced our DIY business. So when you couple just the trends that we see in our existing business coupled with what we see in housing it gives us confidence for the back half of the year.

Simeon Gutman *- Morgan Stanley - Analyst*

Okay, thanks.

Operator

Kate McShane, Citi Research.

Kate McShane - ***Citi Research - Analyst***

Hi, thank you for taking my question. This might sound a little nitpicky so I apologize, but I had noticed in your prepared comments that you had mentioned that kitchen specifically was below the Company average comp. And I was just trying to reconcile the strength that you saw in pro during the quarter versus some of this merchandise commentary and what you're seeing more specifically in terms of what is driving that pro business in Q2?

Ted Decker - ***The Home Depot, Inc. - EVP, Merchandising***

Our overall kitchen business did comp positively. The special order kitchens are not as much of a pro category. The take-with kitchens, our in-stock kitchen business is more of the pro business and that, in fact, was a stronger comp than the special order.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

You would expect to see some seasonality in our kitchen business. People are on vacation during the summertime, putting a new kitchen into your home isn't really top of your mind. We expect the kitchen business to come back in the fall time because it typically does.

Kate McShane - ***Citi Research - Analyst***

Thank you.

Operator

John Baugh, Stifel.

John Baugh - ***Stifel Nicolaus - Analyst***

Thank you. Congratulations on a strong quarter. I was just curious on payables which were quite strong.

You mentioned timing. If you could just talk about the sustainability of that number in the second half and whether your free cash flow assumptions have changed at all for the year? Thank you.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

Hey, John, the payables performance at the end of the quarter was a reflection of increased purchases. Craig commented in his remarks that we had some learnings during the quarter and one of those learnings was actually we had an error in our order logic that we use for inventory purchases and so we corrected that error and have corrected it and actually sent purchases to our suppliers.

So that is just a timing matter. It will normalize itself by the end of the year. So this isn't a consistent trend.

Operator

Christopher Horvers, JPMorgan.

Christopher Horvers - ***JPMorgan - Analyst***

Thanks, good morning. I wanted to talk about inventories a little bit. We have heard a number of vendors talk about inventory de-stocking at retail, orders down in the second quarter.

Is that process largely behind The Home Depot? Does it in any way reflect a less robust outlook for the market?

And I know, Craig, you mentioned learnings and process improvement around inventory management and freight handling. Did that have any impact in terms of what we heard from the vendor community?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

Chris, as Carol just mentioned, one of the learnings this quarter was, in fact, that we did have an error in an update logic that we put into our replenishment. We identified that, corrected it and that clearly did have an impact on the order flow that happened during the quarter. That has been corrected moving forward.

Christopher Horvers - ***JPMorgan - Analyst***

Okay, and just thinking about the weather and thinking about the first half in the upcoming fourth quarter, in retrospect now that you're further along could you reassess the amount of pull-forward and the bathtub effect between the first quarter and the second quarter? And as you think about lapping this upcoming fourth quarter, I think a lot of investors are talking about, hey, you know, The Home Depot really benefited from a warm winter. What's your thoughts on that and do you think the fourth quarter in effect pulled forward demand from the first half of this year?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

It's really, really hard to gauge that. Clearly as we called out in the first quarter we felt that there was some pull-forward.

It's really hard to know exactly how much that happens. Who knows what the weather in the upcoming fourth quarter will be. But we will try to stay focused on driving the business.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

And we know we have a large comp in the fourth quarter of last year that we have to comp on top of and we've planned for that. We will have a great holiday event that we will talk to about next quarter.

Christopher Horvers - ***JPMorgan - Analyst***

Okay, thanks very much.

Operator

Scott Mushkin, Wolfe Research.

Scott Mushkin - ***Wolfe Research - Analyst***

Hey guys, thanks for take my questions. I've got three kind of quick ones.

I think the first one is the 60-day terms that you guys brought forward I think it was in the end of last year, beginning of this year for the pro sales. Any quantification on what you think that's doing to your pro sales as you look at it? I know you've talked about strength there.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

Right. So as we look at sales on our private label card, particularly our commercial private label card, we're really pleased with the results. Sales are year on year ahead of our expectations, our new accounts are double digit ahead of our expectations.

So it's still early days. We're only six months into the program but we are very pleased with what we're seeing.

Now if I could zoom out a little bit and talk about our private label program in total, we actually saw a decline in penetration year on year of about 30 basis points, taking our penetration down to just under 23%. The decline was attributed to a decline in the consumer card. And when we peel back the layers of the onion to say, well, what's happening with the consumer card we see a few things.

Last year we had a few promotional events that we did not repeat this year so that impacted the penetration. And then we see increasing competition coming from bank cards. In fact, I received one just at my home this week from Visa that's offering deferred financing.

So there's increased competition out there. And then, finally, and interestingly, we're seeing a robust penetration increase in PIN debit. PIN debit up over 100 basis points year on year is now the third largest form of tender inside of our Company. So the first largest is the bank card, the second largest is the private label card and the third largest is PIN debit.

Scott Mushkin - ***Wolfe Research - Analyst***

Interesting. Thank you. That's good information.

Have you guys looked at when we go through election cycles what -- we're obviously going to heat up the election cycle and we've heard at the high-end some high-end consumers are postponing certain purchases because of the election cycle. Have you guys looked at your numbers and how does that flow through The Home Depot as we go through the fall?

Craig Menear - The Home Depot, Inc. - Chairman, CEO & President

To be totally honest with you we're focused on our customer. We don't really pay a lot of attention to it. It's all about how do we take care of our customers every single day and make sure we're driving value for them every day.

Scott Mushkin - ***Wolfe Research - Analyst***

My last, is this one is definitely a random question, but it's our second year of Prime Day. Do you guys feel Prime Day as Amazon does it? And then I will yield, thanks.

Ted Decker - ***The Home Depot, Inc. - EVP, Merchandising***

Interestingly on Prime Day there's so much activity in the marketplace it draws a lot of shoppers online and our customers respond. And we have a good day drafting off Prime Day.

Scott Mushkin - ***Wolfe Research - Analyst***

All right perfect. Thank you, guys.

Operator

Budd Bugatch, Raymond James.

Budd Bugatch - ***Raymond James - Analyst***

Good morning, and congratulations on a solid quarter. I guess my first question has to do with the Interline integration. Maybe talk a little bit more, give us a drill down and give us some color of A, what you're doing and B, maybe the impact on the economics of the Company during the quarter.

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

We're again still working through the integration. We're ahead of the value drivers. We like what we see.

But I will let Bill comment on that. He's here.

Bill Lennie - ***The Home Depot, Inc. - EVP, Outside Sales & Service***

Budd, we talked a little bit last call about our customer intercepts and research that we're doing and the prioritization of our use cases where it's based on really the customer feedback plus if you look at the market opportunity. And we have in pilot our first use case which is the ability to enable customers to shop Interline assortments inside The Home Depot stores.

We have a pilot of 20 stores. It's really early days but our results are exceeding expectations. They are really three times expectations.

So it's encouraging. It says that all of the assumptions there have the ability to increase share of wallet with pro, remain intact. And so we will get that and continue to focus on that but again it is very, very early days.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

And in terms of the impact on the quarter, as we talked about our top-line growth exceeded our comp sales growth because of the impact of Interline. We called out the impact on our gross margin. It did have a dilutive impact on our gross margin which we more than made up for with the productivity and supply chain and our co-op and rebate.

And then it does add more variability in expenses. So if you look at our expense growth factor for the quarter, backing out Interline it was a little higher than 60%. As we expected, as we now anniversary the Interline acquisition moving into the third quarter our expense growth factor is going to come more in line with what we expected and, in fact, our expenses are under such good control we were under our expense plan for the second quarter.

We're taking our expense growth factor down from the year. At the beginning of the year we said it would be about 40% of our sales growth. We now think it's about 32% of our sales growth.

Budd Bugatch - *Raymond James - Analyst*

Okay. And my follow-up really has to do with appliances. Double-digit comp if I heard you correct, Ted, how sustainable is that, what is causing that, do you see that in advance of the market itself?

Ted Decker - *The Home Depot, Inc. - EVP, Merchandising*

Well, there's clearly some share opportunity in the marketplace that we've purposely positioned our self for. So we continue to invest in expanding our appliance showrooms with the larger showrooms.

We can put more display pieces on the floor. It allowed us to get a much broader showing of Whirlpool's offering as well as high-end brands like KitchenAid. So we're just a lot more relevant in the space with a better offering.

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

And a double digit comp and appliances meant 50 basis points of total comp growth for our Company.

Budd Bugatch - *Raymond James - Analyst*

Quickly just one follow-up, is pro penetration, can you give us any comment on that as a percentage of sales?

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

It's hovering where it's always hovered, around 40% of sales.

Budd Bugatch - *Raymond James - Analyst*

Thank you very much. Congratulations.

Operator

Michael Lasser, UBS.

Michael Lasser - *UBS - Analyst*

Good morning, thanks a lot for taking my question. Craig, how long do you think that home improvement demand can remain decoupled from other elements of the economy, other elements of retail?

I think Carol in her prepared remarks noted that economic prognostications have been ratcheted down but you're keeping your forecast for same-store sales in play. So how long do you think that this can be kind of an oasis within the broader economy?

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

Well, I think when you look at a few factors, first of all there's about 4.6 months of supply. Average historical is about six months. So that certainly means there's opportunity as you go forward.

That's also helping to keep home value appreciation going. And there's projections in the market out there from various sources that would say home value appreciation continues for the next couple of years for sure. And so I think this is a tailwind that we see for the foreseeable future and the guidance window that we've given.

Michael Lasser - *UBS - Analyst*

And if you look at some of the housing markets that have gotten really hot, San Francisco, Miami, are you seeing similar trends there? Or any sign that demand is starting to ebb out?

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

We don't really see any change.

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

We haven't seen any change. The fundamentals as Craig pointed out for housing and then the impact to home improvement are really, really good.

And you go back to household formation, if the number of people in households were to drop to the 2000 level it would create 4.3 million new households. Will they all go into single family owned households? No, but we serve both.

We serve owned household and we serve rental households. So there's just a tremendous amount of talent that continues to support our business and our business outlook through 2016 and into 2017 for sure, if not 2018 and 2019.

Michael Lasser - *UBS - Analyst*

And my follow-up question is on the implementation of COM along with change in your ordering algorithm that you implemented in the quarter. Did it have any impact on sales, did it drag down sales at all, did it have any impact on in-stocks?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

It's really hard to know. We really don't know and the reason that we don't is there's so many items, candidly, in the store that can be substituted.

So if we cause ourselves hurt in one item it is very possible that a customer picked up another item. So it's pretty difficult to tell.

Michael Lasser - ***UBS - Analyst***

Understood. Good luck with the second half of the year.

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

Thank you.

Operator

Seth Sigman, Credit Suisse.

Seth Sigman - ***Credit Suisse - Analyst***

Thanks, good morning. Great quarter, guys. I just wanted to follow-up one of the last questions.

So you exited the quarter with a pretty healthy trend. It sounds like the tone is positive on the demand outlook. Is there anything we should be thinking about in terms of the cadence of comp growth in the back half of the year Q3 versus Q4?

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

The way that we've built our plan and our forecast is that the comps for Q3 and Q4 will be more or less the same. Shouldn't see a lot of variability there.

Now where you will see variability is on the expense growth factor. The expense growth factor will be higher in the third quarter than it is in the fourth quarter principally because of year-over-year comparisons. For the full year the expense growth factor should be about 32% of our sales growth.

Seth Sigman - ***Credit Suisse - Analyst***

Okay, that's helpful. Then maybe just to dig in a little bit further, have you seen any major change in trends or the demand outlook exiting the quarter like early in the third quarter here?

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

We're very pleased with our August results. Parts of the country obviously are flooded. We have a store closed in Louisiana and we our heart goes out to the people who were impacted by that, but if you ignore that kind of activity we're very pleased.

Seth Sigman - *Credit Suisse - Analyst*

Okay, got it. And then one of the things you guys talked about is the growth in units per transaction. I'm just wondering, is there a change in trend there?

And if so do you think that's a result of some of the initiatives? Or is the competition of the projects that are getting done right now maybe a little bit different? Like how do you think about that trend?

Ted Decker - *The Home Depot, Inc. - EVP, Merchandising*

I think the units per transaction, this is about the third quarter now that when you think of all the positive comps we've had over the past several years the units per transaction really didn't move that much. But the last few quarters we've seen a healthy growth in units per transaction and it's really units in the larger ticket items.

When you start to get into larger ticket items you're looking at 40, 50, 60, even 70 items in a basket. So this is clearly a project.

While appliance sale, for example, would help the average ticket, you're only looking at one or two items, the appliance and maybe some connecting hoses. But our project business remains very healthy and the growth of that unit per transaction, and units and things like lumber and building materials are very healthy for the business. So it speaks to pro and it speaks to project.

Seth Sigman - *Credit Suisse - Analyst*

That's great color. Thanks very much.

Operator

Peter Benedict, Robert W. Baird.

Peter Benedict - *Robert W. Baird - Analyst*

Hey guys, just following up on that, is there any historical perspective you guys can provide us with around this units per transaction trend that you're seeing? How does the current metrics compare to any periods in the past?

And when you've started to see an uptick historically, how long does that go on for? Is there any prospective around that you can help us with? Thank you.

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

The granularity in items per basket, our history is not so good. Our record keeping is not so extensive. So we can't really go back to prior periods.

But what we can currently, and this is I think a really good news story in terms of the health of the pro, is that while high spend pros drove the out-performance the gap between high spend pros and low spend pros is narrowing. And as that gap narrows as we would expect that's a sign of health in the pro space. So we would expect this trend in items per basket to continue.

Peter Benedict - ***Robert W. Baird - Analyst***

Okay, Carol, thanks. That's helpful.

Then my one follow-up would be just curious if you guys are seeing anything around mix shifts within categories, building products in particular? Any evidence of any trade-up going on or anything like that? Thank you.

Ted Decker - ***The Home Depot, Inc. - EVP, Merchandising***

Well, we've continued to see trade-up. We've talked about this in the last several core calls where we're looking at all our price points. And, again, we had another quarter where our comp progression moves as we go up the line structure from good, better, best.

Specific to pro pricing I'd say the only call out would be lumber prices are on the move and you're starting to get some trade-off between plywood and OSV. Just as those prices get back elevated, the more premium product in plywood there's isn't as much of a gap in that product class.

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

Clearly innovation is a driver, too. The customer is stepping up in the line structure. When you provide new, innovative products people step in.

Peter Benedict - ***Robert W. Baird - Analyst***

Okay, makes sense. Thanks very much.

Operator

Dan Binder, Jefferies.

Dan Binder - ***Jefferies & Co. - Analyst***

Thank you. I just want to go back to the comment you made earlier about the replenishment. I was just curious if it was significant enough that it created any in-stock or in-stock issues or lost sales impact?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

We definitely saw an impact in our in-stock position for about six weeks during the quarter but clearly have recovered from that at this point.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

And let's put that in perspective for you. We strive to have in-stocks of 99% or greater. As Craig pointed we were six weeks under that goal but the largest gap was 13 basis point, so it wasn't a major disruption but because of our standards to be 99% or better we felt it.

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

We missed our own expectations.

Dan Binder - ***Jefferies & Co. - Analyst***

Okay, great. And then you mentioned earlier that there were certain promotions you didn't repeat causing the private label penetration on credit to come down a bit. I was just curious on that, if you talk a little bit about your promotional posture, how you're thinking about promotions relative to the market both from big-box, online, anything you can share with us on that front that would be great.

Ted Decker - ***The Home Depot, Inc. - EVP, Merchandising***

I would say that we have really redoubled our efforts to focus on everyday value for the customer. So we are increasingly focused on providing the best product, the best brand at the best prices every day for all of our customers regardless how they pay.

Dan Binder - ***Jefferies & Co. - Analyst***

Okay. Last one for you if you could.

Last year there was a willingness to take on some more debt for a share buyback. Thus far you have stuck to the $5 billion share buyback.

Is there a scenario where you could see the leverage increase a bit? I think you are still under that two times adjusted debt to EBITDAR at this point.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

We are. We are around 1.8 times which gives us about $3 billion of our own capacity relative to our targets. It is not our intent to let that borrowing capacity continue to grow, and as we have in the past we've opportunistically taken advantage of interest rates and availability to raise incremental debt and increase our share repurchase.

So you should think about our past practice is something that we should continue in the future. But we like to guide based on what we know today am what we know today is excess cash to buy back shares. And if we'd like to issue some incremental debt and buy back some additional shares we will let you know.

Dan Binder - ***Jefferies & Co. - Analyst***

Great. Thank you for much.

Operator

Brian Nagel, Oppenheimer.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Hi, good morning. Nice quarter.

My first question, I apologize, it may be somewhat repetitive to some of the prior questions, but just to be clear, and I think someone else mentioned there's been a lot of noise out there in retail sales lately from what other companies are talking about and clearly we talk about weather. But as you look at the data even more granular than what we discussed today, are you seeing anything to suggest or anything to hint at a more cautious consumer environment, particularly in the bigger ticket type projects?

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

As we said we're fortunate that we are in a space where the customer is willing to spend. That's clearly driven by the dynamics that exist in the housing market overall.

And as Ted called out, we had a strong performance in tickets above $900 growing 8.1% in the quarter and driven not only by big-ticket categories like HVAC and appliances but by the units per basket around the project business. So it's very encouraging what we're seeing in that.

Brian Nagel - *Oppenheimer & Co. - Analyst*

A follow-up, Carol, on the expense leverage side. For a while now it seems that Home Depot continues to beat expectations with regard to expense leverage.

You mentioned that again today with the now higher EPS guidance for the year. So maybe more color on exactly where this latest bit of beat is coming from? And as you look out, is there anything to suggest that at some point Home Depot could really have a more difficult time leveraging expenses or are there continued opportunities?

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

Well, we view for productivity as a virtuous cycle in our business and we are constantly looking at ways to drive productivity while ensuring that the customer experience is the best it possibly can be. Most recently our HR team did a great job of renegotiating some contracts in support of our medical benefit programs for our associates and that reduction has caused actually a cost out and with that cost out our people costs aren't going to be as high this year as we anticipated. That benefit will flow through into 2017 which is a good news story.

And there are other examples of that. I won't bore you with all those examples, but there are other examples of where our team continues to go after large purchasing contracts to drive productivity and make sure that the experience is the one that we want to deliver.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Thank you, and congrats again.

Operator

Scot Ciccarelli, RBC Capital Markets.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

I know you guys are focused on everyday value I know you already commented on that. But there was some noise in the quarter regarding heightened promotional cadence around some of the competitors in your space. Is there anything to note from your vantage point regarding changes in the promotional environment?

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

From time to time we see increases in promotional activity. We saw it certainly during the quarter but we're focused on driving everyday value for our customers.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

Okay, so nothing of note. And then Carol, I know one of the things you've talked about increasingly over the last couple of quarters is the aging housing stock in the U.S.

I'm curious if you've started to come to any conclusions regarding how big of a driver or impact that could be on your business over time? Thanks.

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

Well, we're doing more research in this regard because we've never been in this place in our country, so we don't have any history to rely on. So we've got more research to do.

It actually makes us comfortable about our growth forecast as we go into 2017 because when things start to break you've got to fix it. And we think it's tailwind, but Scot I can't quantify it yet. Maybe when we'll get that research done by the end of next quarter we can give you some more thoughts.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

That would be great. Thanks, guys.

Operator

Jessica Mace, Nomura Securities.

Jessica Mace - *Nomura Securities - Analyst*

Hi, good morning. My question is a follow-up on the supply chain.
You talked about it being a work in progress. And you mentioned that COM system and some other factors but I was wondering if you could just give us a little bit more detail on the next milestones that we should be expecting and what that impact could be on the P&L. Thank you.

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

So we do view the supply chain as an ongoing, continued opportunity to optimize. The next big initiative in that is supply chain Sync and Mark Holifield is here. I will let Mark comment.

Mark Holifield - ***The Home Depot, Inc. - EVP, Supply Chain and Product Development***

Yes, we're pleased. As we've mentioned it is a work in progress. We continue to seek opportunity to improve our in-stock, our inventory productivity, our logistics cost.

Sync is the biggest initiative we have going in that. Sync is currently in two-thirds of our RDCs, 12 of our 18 RDCs and we're handling about 60% of the cost of goods sold, the dollar volume that goes through there on the Sync initiative.

From that we're seeing mainly improved transportation costs and smoother demand flow and we're working with our suppliers to continue to improve those benefits for all in the supply chain. So we'll continue along that path but we're not in a hurry. It's still early days and it's a multiyear initiative that we're pursuing there.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

To put it in perspective, between 2011 and 2015 on a cumulative basis our supply chain has driven 68 basis points of gross margin expansion. So it's been very productive for us. We called out the productivity that we experienced in the second quarter and year to date we've had about 12 or 13 basis points of productivity.

So we continue to anticipate benefits coming on the gross margin line through the productivity in our supply chain and also there will be longer-term inventory turn benefits. We never want to go out of stock but there will be longer-term inventory turn opportunities.

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

And that really comes from shortening lead times.

Jessica Mace - ***Nomura Securities - Analyst***

Great, thank you for taking the question.

Operator

Greg Melich, Evercore ISI.

Greg Melich - ***Evercore ISI - Analyst***

Hi, thanks. I'd love to dig a little deeper into the digital online business. I think up 19%, still quite strong but it is decelerating.

Is that just the law of large numbers? Was there something given all the initiatives you have whether it be Sync or supply chain changes or getting ready for BOFDS that's impacted that?

Ted Decker - ***The Home Depot, Inc. - EVP, Merchandising***

We don't look at it as a deceleration on a nominal dollar basis. We've now grown over $200 million for 14 quarters. One change was that the patio line structure I spoke about. We put more value product into the store that really sold incredibly well.

And that took about 2, 3 points of comp off our online number. So we've been running about 20-ish, 20-plus for several quarters now growing the business $200 million a quarter.

Greg Melich - ***Evercore ISI - Analyst***

Got you. Just make sure I got the numbers right, I think you mentioned 42% of online now is done through the stores and I want to make sure I got that right. And two, as you go through this Deliver from Store how do you think about that in terms of how it could change the as online business?

Ted Decker - ***The Home Depot, Inc. - EVP, Merchandising***

Yes, that's right. So 42% of online orders are picked up in the store and 90% of returns are processed in the store. And then one of the big benefits following the rollout of COM is we are now following with what we call BOFDS which is Buy Online, Deliver from Store.

We've always delivered from our stores. The difference now is you can execute the transaction online and pick a much shorter delivery window for your delivery. We're in about 700-plus stores now with Buy Online, Deliver from Store.

Very early days. We will be finished with that rollout by the end of this year.

And we're seeing really nice pickup from our customers in reuse, particularly our pros who have used Buy Online, Deliver from Store are coming back and using it as second and third time. So we think that fulfillment number, which is the 42%, will grow when we include BODFS deliveries in that number. It's very early right now.

Greg Melich - ***Evercore ISI - Analyst***

That's great. Thanks a lot. Good luck.

Diane Dayhoff - ***The Home Depot, Inc. - VP, IR***

We have time for one more question.

Operator

Laura Champine, Roe Equity Research.

Laura Champine - ***Roe Equity Research - Analyst***

Good morning. I wanted to dig a little deeper into what's going on with the pro.

Do you think that you are benefiting from the growth in the market or are you actually taking market share with pros? And then assuming you're taking share with pros do you see more strength with smaller pros, larger pros, what categories are you dominating that's driving that share gain?

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

I definitely think that the market in total, at least when you talk to pros they are busier than they were a year ago. So the market growth is certainly there. When we look at the strength in our pro categories we believe based on all the data that we have that we're taking share in those categories, as well.

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

If you think about it, Laura, based on the census data which is NAICS4441 we grew share year on year. And since pro outpaced DIY growth it had to be share coming from in the pro space. So clearly the market is growing but we are taking share at the same time.

Laura Champine - *Roe Equity Research - Analyst*

Got it. And any comments on the strength of the smaller pro versus the larger pro?

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

As I mentioned earlier what we've seen is a narrowing between the large spend pro and the high spend pro in terms of the rate of growth. And that is a very healthy sign.

Laura Champine - *Roe Equity Research - Analyst*

Got it. Thank you.

Diane Dayhoff - *The Home Depot, Inc. - VP, IR*

Thank you for joining us today. And we look forward to having you join us on our next quarterly earnings call in November.

Operator

That does conclude today's conference call. You may disconnect at this time. We do appreciate your participation.