HD – Q3 2016 Home Depot Earnings Call
EVENT DATE/TIME: November 15, 2016 / 09:00AM ET

PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to The Home Depot third-quarter 2016 earnings conference call. Today's call 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, Catherine 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 really would appreciate it if the participants would limit themselves to one question with one follow-up, please. If we are unable to get your question during the call, please call our investor relations department at 770-384-2387.

Before 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 strong quarter for both sales and earnings as we continued to see strength across our business. Sales for the third quarter were $23.2 billion, up 6.1 percent from last year. Comp sales were up 5.5 percent from last year, and our U.S. stores had a positive comp of 5.9 percent. Diluted earnings per share were $1.60 in the third quarter, up 18.5 percent versus last year.

In the U.S., all three of our divisions posted positive comps in the third quarter, led by our Southern division. All of our regions positively comped, except one region in the North. In New England we had a small negative comp due primarily to a state sales tax holiday in fiscal 2015 that did not repeat in 2016.

Internationally, our Mexican and Canadian businesses had another quarter of solid performance. Mexico and Canada reported positive comps in local currency marking fifty-two and twenty consecutive quarters of positive comp growth, respectively.

As Ted will detail, we saw balanced growth from both ticket and transactions. All of our merchandising departments posted positive comps, and we saw a healthy balance of growth among both our Pro and DIY customers, with Pro sales growing faster than DIY sales in the quarter. Our Pro business continues to be driven by a strong offering of brands that pros demand, consistent product innovation, as well as enhanced delivery and credit offerings to help them more efficiently manage their business.

In the third quarter we anniversaried the acquisition of Interline and are proud of the team's efforts in this first year. The Interline integration continues to progress as we work to execute against the business use cases to leverage Interline's capabilities. We are excited about the opportunity Interline provides us to expand our share of wallet with customers.

We continue to see double-digit sales growth from our online business. This quarter, online sales grew over 17 percent, and represented 5.6 percent of overall sales. Over 40 percent of our online orders are picked up in the store, which we view as a positive sign of our physical store's continued relevance with our customers.

This quarter, we rolled out a complete HD.com re-design. Content was enhanced to display in full screen, optimizing our desktop and tablet displays for customers.

You will recall that during last year's third quarter we opened and began shipping from our third direct fulfillment center, or DFC, in the U.S. With this distribution infrastructure in place, we have been able to better serve the needs of our online customers faster and more directly. We are still assorting the appropriate products to house in our three DFCs, but we've been able to reduce delivery costs and improve the overall customer experience.

We continue to invest in our supply chain transformation by optimizing our network through initiatives like Supply Chain Sync. This quarter we began the rollout of Sync to our Northern division, and we continue to onboard new suppliers in the Southern and Western divisions. As you know, this is a multi-year, multi-phase endeavor, but we are pleased with our progress thus far.

Changing customer expectations are requiring that we simplify our operations in order to improve productivity and at the same time reinvest in the customer experience. Our efforts to drive operational excellence in freight handling in the stores are doing just that. Reducing both time and footsteps needed to move freight end-to-end, or from truck to shelf, will enable us to re-allocate associate time to enhance the customer experience.

One way we are reinvesting in the customer experience is through initiatives like COM and BODFS. As you will recall, COM is our new customer order management system that was fully deployed last quarter in all U.S. stores. And BODFS, or buy online deliver from store, remains on track to be rolled out by the end of the fiscal year. In the 1,600 plus stores where we have BODFS, our on-time delivery service is now exceeding our target, and we have seen double-digit increase in the number of deliveries. We are pleased with the positive customer response to this enhanced delivery option.

Turning to the macro environment, we believe home price appreciation, housing turnover, household formation and an aging housing stock in the U.S. continue to support growth in our business. As Carol will detail, we are reaffirming our sales growth and lifting our earnings per share growth guidance for the year.

Let me close by thanking our 400,000 plus associates for their hard work, dedication and commitment to our customers. I'd like to give a special thanks to all associates and suppliers who have worked to help the communities impacted by Hurricane Matthew and the flooding in Louisiana. They have worked tirelessly under difficult circumstances, often in the face of disruption in their own lives caused by these storms. Service to our communities is a core part of the Home Depot culture, and we are very proud of their efforts.

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 third quarter. We saw strength across the store, balanced between the Pro and DIY customer, as well as continued growth in our online business.

All of our merchandising departments posted positive comps, led by appliances, which had double-digit comps in the quarter. Lumber, tools, outdoor garden, indoor garden, lighting, decor, and flooring were above the company's average comp. Plumbing, hardware, building materials, kitchen and bath, millwork, electrical, and paint were positive but below the company average.

We continued to see balanced growth between transactions and average ticket in the quarter. Total comp transactions increased 2.4 percent, while comp average ticket grew by 3.1 percent. Our average ticket increase was slightly impacted by commodity price inflation, mainly from lumber and building materials. The total impact to ticket growth from commodity price inflation was approximately 35 basis points. In addition, our average ticket growth was negatively impacted by approximately 33 basis points, primarily due to a weaker Mexican peso.

Looking at big ticket sales in the third quarter, transactions over $900, which represent approximately 20 percent of our U.S. sales, were up 11.3 percent. The drivers behind the increase in big ticket purchases were appliances, flooring, and roofing.

Once again, we saw strong outperformance in many Pro-heavy categories, as Pro sales grew faster than the company's average comp. This led to strong comps in commercial and industrial lighting, fencing, plywood, pressure treated decking, and interior doors.

At the same time, we also saw strength with the DIY customer, as they undertook various projects around the house. This project business drove strong comps in special order carpet, tool storage, laminate flooring, and vanities.

Weather remained favorable throughout the quarter and extended the outdoor project selling season. By leveraging forecast analytics, strong supplier collaboration, and our flexible supply chain, we were able to meet customer demand throughout the prolonged selling season. Categories such as lawn mowers, seed, planters, fertilizers, and soils and mulch posted comps above the company average.

As Craig mentioned, our vendor partners, supply chain, and internal teams rallied to support our customers impacted by Hurricane Matthew and the flooding in Louisiana. Through strong collaboration, we were able to get product to our communities in their time of need. We estimate the impact of storm-related sales in the quarter to be approximately $100 million.

During the quarter, we held our annual Halloween, Harvest, and Labor Day events. These events were a huge success and increased both foot traffic in our stores and volume online. We experienced robust comps in decorative holiday, appliances, and power tools.

Turning to our interconnected business, we made some significant changes to our online experiences in the third quarter. We rolled out an updated HD.com site and redesigned our app, both without interruption. The update includes an expanded buy box, which now makes it easier for our customers to select their preferred fulfillment option at checkout, whether that be delivered to home or picked up in store. These changes have already yielded positive results, as we have seen improvements in overall site performance.

Now, let’s turn our attention to the fourth quarter.

Product innovation remains a key part of our strategy. Adding to our broad lineup of professional grade power tools, we are excited to introduce two new breakthroughs.

From Milwaukee, we are launching a 9 amp-hour lithium battery. This battery pack delivers up to 5 times the run time, 35 percent more power, and runs 60 percent cooler than standard lithium battery packs, saving customers valuable time and money. The new battery is fully compatible with more than one hundred Milwaukee M18 tools, and provides the next big step towards complete corded replacement. This new and advanced battery is a big box exclusive to The Home Depot.

From Makita, we are excited to announce the new Sub Compact Drill and Impact Driver. These revolutionary new tools are the smallest pro tools on the market delivering 18-volt power. The electronically-controlled brushless motor in these products enables them to run cooler and more efficiently, while at the same time matching the torque and RPMs needed to meet the demands of the Pro customer. These products are another big box exclusive to The Home Depot.

The winter season and cooler temperatures are rapidly approaching, and we have a great lineup of excellent values and special buys for our customers during our Black Friday, Holiday, and Gift Center events. One product to look for this holiday season is the exciting new Star Shower Motion Laser Light. This new and improved laser light projector not only projects thousands of green and red stars for a festive display on the front of the home, but it also turns into a motion laser light show at the press of a button. This product is channel exclusive to The Home Depot.

Our upcoming events, new product launches, and outstanding execution by our associates will help drive a great holiday season.

With that, I'd like to turn the call over to Carol.

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

Thank you, Ted, and hello everyone.

In the third quarter sales were $23.2 billion, a 6.1% increase from last year driven primarily by positive comp sales as well as the impact of Interline brand. Versus last year, foreign currency rates, primarily a weaker Mexican peso, negatively impacted total sales growth by approximately $76 million or 0.35%.

Our total Company comps or same-store sales were positive 5.5% for the quarter with positive comps of 3.8% in August, 6.5% in September, and 6.1% in October. Comps for US stores were positive 5.9% for the quarter with positive comps of 4.2% in August, 6.9% in September, and 6.5% in October.

One last comment on comps, while we are on a path to fully integrate Interline Brands we aren't at a point where it makes sense to include its results in our comps and operational sales metrics. When the business becomes more integrated we will include Interline's results in our operational metrics.

Our total Company gross margin was 34.7% for the quarter, an increase of 6 basis points from last year. The change in our gross margin is explained largely by the following factors: first, as expected we had 24 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 finally, we had 17 basis points of gross margin expansion arising from a change in the mix of product sold and improvement in inventory shrinkage.

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 third quarter operating expense as a percent of sales decreased by 62 basis points to 20.4%. In the quarter we had some expenses that we did not plan for including $23 million of legal expenses related to our 2014 data breach and approximately $15 million of storm-related clean-up expenses.

Even with this unplanned expense pressure we delivered total expenses under our plan. For the year we expect our expenses to grow at approximately 32% of our fiscal 2016 sales growth rate.

Our operating margin for the quarter was 14.3%, an increase of 68 basis points from last year. Interest and other expense for the third quarter was $236 million, down $4 million from last year.

In the third quarter our effective tax rate was 36.2%. For fiscal 2016 we expect our income tax provision rate to be approximately 36.7%. Our diluted earnings per share for the third quarter were $1.60, an increase of 18.5% from last year.

Now turning to the balance sheet, at the end of the quarter merchandise inventories were $13.2 billion, up $746 million from last year. Inventory turns were 5 times, flat with the third quarter of last year. Year over year, accounts payable grew slightly faster than inventory, increasing by $818 million to $8.1 billion. In the third quarter we repurchased $2.1 billion or approximately 16.4 million shares of outstanding stock, bringing our year-to-date share repurchases to approximately $4.6 billion.

Additionally, during the quarter we took advantage of an attractive interest rate environment and raised $2 billion of incremental long-term debt including a $1 billion tranche with a record-setting 40-year maturity carrying a coupon of 3.5%. We will use the proceeds of this debt issuance to repurchase outstanding shares, bringing our targeted fiscal 2016 share repurchases to $7 billion.

Accordingly, we expect to repurchase approximately $2.4 billion of outstanding shares in the fourth quarter. Computed on the average of beginning and ending long-term debt and equity for the trailing four quarters, return on invested capital was 29.1%, 280 basis points higher than the third quarter of fiscal 2015.

Moving to our guidance, we remain encouraged by the strength of our core business. Our outlook for the remainder of the year reflects modest GDP growth, continued benefit from the US housing market and, candidly, some market share gains. While we have tough fourth-quarter comparisons, as Ted described we plan for them.

Today we are reaffirming our sales growth guidance. For fiscal 2016 we expect sales to grow by approximately 6.3% with comps of approximately 4.9%. Note that our sales forecast assumes foreign currency exchange rates as of the end of our fiscal third quarter.

For earnings per share we have tightened up our tax provision and outstanding share forecast and are lifting our guidance. We now expect fiscal 2016 diluted earnings per share to grow by approximately 15.9% to $6.33.

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

QUESTION AND ANSWER

Operator

(Operator Instructions) Michael Lasser, UBS.

Michael Lasser - *UBS – Analyst*

Good morning, thanks a lot for taking my question. Craig, the key question here is how do you comp the comp in the fourth quarter and the first quarter?

Given the very cooperative weather conditions that you saw last year, I know you briefly touched on that. But maybe you could provide a little more detail. Plus, what are you looking for to ensure that you don't misread the state of the cycle and either respond too quickly or too slowly to potentially changing market conditions?

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

So on how do we comp the comp, as I recall this was the conversation we had going into fiscal 2016 coming out of last year. Quite honestly that's the hard work that the team does immediately following the performance that we had last year in the fourth quarter. We are up against big numbers. US comp in the fourth quarter last was 8.9%. But that's really the work the team started doing immediately following the close of that quarter. So we feel confident in the programs that the merchant teams have laid out, the support with the supply chain teams and then, of course our, store associates taking those programs and driving them. Quite honestly that's our job, that's what we need to do.

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

And if I could just jump in, this is Carol here, here we are in the middle of November and we are on track to deliver the sales that we just guided to.

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

And then in terms of what we look at so that we don't miss anything, we've shared in the past, I think, that we are constantly watching ticket and transaction. And when you step away from the downturn in the mid-2000s, the previous downturn was 2001 and we saw a decline in average ticket that was a little bit of a leading indicator. You have to be careful because ticket can be affected by things like weather. So when you have big-ticket sales, for example, in the first and second quarter on things like tractors weather can impact that. So we do watch ticket carefully, we balance that with transactions. What we are seeing in the business right now we like a lot, we see a nice balance between ticket and transactions.

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

And, in fact, transactions accelerated through the quarter.

Michael Lasser - *UBS – Analyst*

Throughout the quarter?

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

Yes sir.

Michael Lasser - ***UBS – Analyst***

And, Carol, you mentioned that you anticipate some share gains in the fourth quarter. Historically you really haven't factored share gains into your longer-term outlook. What is changing now that's giving you the confidence to put that in there where you hadn't in the past?

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

Well, we look at the environment we see that there are share donors in certain categories. Ted called out that appliances was a double-digit comp for us in the third quarter. It contributed 50 basis points of our overall growth in the quarter as for the year. So as we look to the fourth quarter it's always a big appliance selling season. We would expect to continue to grow appliances in the fourth quarter.

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

And Michael, we've obviously made a lot of investments over the past few years to make sure we are positioned to be able to capture that.

Michael Lasser - ***UBS – Analyst***

OK. If I could add one last one on the SG&A, recognizing that you have one-time items quarter in, quarter out, good guys and not so good guys, yet the SG&A has been growing 2% to 4% after being up at a much more moderate pace, I'm talking about a per square foot basis. So are we just at a point where the business requires a little bit more investment because you've had so many years of strong comp and so the flow-through might not be as strong moving forward?

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

If I could take you back to the beginning of the year, we said that our expenses would grow at 40% of our sales growth rate. We are now seeing that our expenses this year will grow at 32% of our sales growth rate. What that means year to date our expenses have grown at 37.5% of our sales growth rate. So in the fourth quarter you should expect a lot of leverage on the SG&A line, principally because we have year-over-year expense items that we will not repeat in the fourth quarter of this year. Last year we had out-performance and bonus, we had some store cleanup costs. Those items will not repeat in the fourth quarter at this year. So expect a good flow-through. Longer term as we've talked about, and we talked about this at the beginning of the year, because of items like rising people costs, and we are not alone, all companies are faced with rising people cost, over the longer term we would expect our expenses to grow at 50% of our sales growth rate. We are not providing guidance for 2017 today, but you would expect next year for us to come back and tell you it should be more in the 50% area.

Michael Lasser - ***UBS – Analyst***

Excellent. Thanks so much.

Operator

Seth Sigman, Credit Suisse.

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

Thanks and good morning. I just want to follow up on the question about the cycle and the outlook for demand in the category.

Can you give us a sense of what you are seeing in terms of bigger ticket discretionary projects? Are you seeing any sort of change in the types of projects consumers or pros are focused on? Basically anything that would indicate that we are maybe heading into a different part of the cycle.

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

So when you look at the larger ticket sales it is coming we believe from multiple areas. It's coming from the strength in the pro-business, it is coming from our services business, it is coming from things like the appliance sales growth.
So it's a broad aspect of drivers behind the ticket. When you look at the third quarter actually our transactions over $900 was the largest quarter growth of the year.

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

I think it's important to step back and look at where we are in terms of the cycle and focus on home price appreciation because that's a big driver of our business. Since 2011 homeowners have seen a 95% increase in their home equity. That's come about because of rising prices as well as if you have a mortgage you've been making more mortgage payments since 2011. So homeowners really do view them at home as an investment and not an expense. So the question is, okay, great, what does it mean for 2017 and beyond? Well, we see home prices have recovered in certain parts of the country.
There are other parts of the country where we are still double-digit down from peak. Those areas include Chicago and Atlanta, so in terms of where we are for the cycle you can't look at the averages because the averages will kill you. You have to look at the markets, and when you look at the market we see real opportunity for continued improvement.
There's a really interesting statistic that comes out of the Harvard Joint Center for Housing Studies. And they call it the leading indicator of remodeling activity. This leading indicator of remodeling activity suggests continued growth throughout the fourth quarters throughout 2017. They don't produce the report past 2017 but their work suggests we will continue to grow.

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

Okay, thanks for that. And then maybe a good follow-up here would be you guys have rolled out a couple of key offerings to better serve the pro including credit and advanced delivery options. I know it's very early, but do you think that's playing a role in driving big-ticket and the strength we saw this quarter? And do you think these options are driving in maybe a different customer or changing behavior within the store?

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

As you said, we are still in the process of rolling out. It's early days. We have not completed the rollout of BODFS, our Buy Online Deliver From Store, yet. We are now up to about 1,600 stores where we've launched the program. As I mentioned in my comments, we've seen double-digit growth in deliveries. So certainly we think that that is beginning to have a positive impact and making it easier for our pro customers as well as our DIY customers to engage and shop with The Home Depot.

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

On the credit side it is important to note that we have a little over 900,000 pros that hold a private-label credit card with us. We've converted over 20% of those pros on to our new value prop. And for those that have converted, 64% of those are activating the new value prop. So we see growth in those accounts and as we continue to convert and add new pros into the program we expect this to be a top-line benefit. Today it's growing, it's not materially impacting the top line but it is growing and we expect that to continue to grow over time.

Seth Sigman – *Credit Suisse - Analyst*

That's great color. Thanks very much.

Operator

Christopher Horvers, JPMorgan.

Christopher Horvers – *JPMorgan – Analyst*

Thanks, good morning everybody. So I wanted to follow up on the hurricane. The hundred million dollars of sales related to storms, is that hurricane and flooding combined? And just related to the hurricane, can you talk about how much the hurricane lifted the month of October in the US?

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

The number is both in total. Candidly, the flooding has been an impact throughout the entire quarter and a larger driver.

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

It was the biggest part of that $100 million.

Christopher Horvers – *JPMorgan – Analyst*

Oh, Interesting. So the hurricane lift to October actually sounds like it was certainly, if you are talking about 50 basis points for the quarter and most of that being related to flooding then maybe 50, 70 basis points of lift to the month of October simply from the hurricane?

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

Not that much. Just the timing of the hurricane and where it hit, not that much. We saw significant cost come out of the flooding. In fact, we had to shut down a store, we lost a store. Part of those storm-related expenses I called out on the SG&A line is because we had to basically liquidate the inventory, clean up the store and get it back open which we did do, which is very exciting for us.

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

The flooding happened at the end of Q2. So the flooding impact was the entire quarter and was a much bigger impact. Obviously, the hurricane was in October.

Christopher Horvers – *JPMorgan – Analyst*

Understood. And then one of the questions that we are getting is how you are thinking about or what's implied in the fourth quarter related to annual guidance? I think some of the more skeptical investors out there are saying hey, look, Home Depot is implying EPS and comps below where the street is sitting for the fourth quarter. So can you talk about how you thought about approaching the guidance on the year and then how you thought about addressing those questions to investors?

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

I think the easiest way to think about this is on a two-year stack basis. So the implied comp for the fourth quarter is a little over 3%. If you look at the two-year stack, for the first half of 2016 the two-year stack comp is 10.6%. If you look at the two-year stack comp for Q3 it's 10.6%. If you look then at the forecasted two-year stack comp for Q4 it's over 10%. So skepticism abound, but we feel very comfortable with the guidance that we give based on this two-year stack.

Christopher Horvers – *JPMorgan – Analyst*

Perfect. Thank you very much.

Operator

Scott Mushkin, Wolfe Research.

Scott Mushkin – *Wolfe Research - Analyst*

Thanks, guys. Thanks for taking my questions. I just wanted to poke a little bit more about, thinking about the environment going forward. Obviously, we had a big election and the market has taken off. But as we think about your business obviously pro was growing pretty fast but we have SG&A maybe growing about 50% of sales I think is what has been said.
So as we think about the construct of 2017 and beyond and knowing that there's a lot of dry powder in the housing market, how do you guys think about your growth rate as we move out of the fourth quarter which has got a lot of noise and go into 2017 and 2018? Do you think we are at the end of the cycle or could this cycle be a lot different?

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

The first comment I would make, obviously we are not prepared to talk about 2017, we will do that on our next call. But what I would say is if you look at the drivers of growth we don't see significant change in the drivers of growth. We have had foundational GDP growth, we have had in housing home value appreciation, housing turnover, new household formation and then layer on top of that 65% of the housing stock in the US is now in excess of 30-years old. All of those are drivers of business for us. There is nothing that would indicate that we see that those would change, and as Carol said there's varying degrees of recovery amongst different parts of the country. So we don't see anything on the horizon at this stage that would say anything should change in terms of the growth drivers in our business.

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

And if you recall the investor conference we had in December of last year, we set forth a sales target of $101 billion and operating margin target of 14.5% by 2018. As we sit here today nothing has taken us off of that target.

Scott Mushkin – *Wolfe Research – Analyst*

I guess I was even thinking the more bullish side, could we, the recovery we've called a zombie economy, grow session, we've had a lot of different of words we've used for it. Is it conceivable as you look at your business over the last three or four years that it's been obviously very good but a better environment, a better macro environment could drive growth higher? Have you thought about that?

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

It's possible but we're focused on the numbers that Carol just shared that we laid out in our investor conference. That's roughly $12 billion-plus worth of growth between now and 2018 from where we started this year and that's the equivalent of opening 357 new Home Depot stores, which we won't do. So that's no small hill and we are focused on achieving those numbers.

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

The cool thing is, Scott, we've got a supply chain, we've got a staffing model, we can adopt or change, adjust to whatever demand is coming our way.

Scott Mushkin – ***Wolfe Research – Analyst***

Thank you for that. And then just one clarification, was the pro-growth sequentially, is it sequentially speeding up? And then I will yield, thank you.

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

The pro-growth was higher than the DIY growth in the third quarter. But the sequential comment had to do with transactions, not customer segment.

Scott Mushkin – ***Wolfe Research – Analyst***

Thank you.

Operator

Simeon Gutman, Morgan Stanley.

Simeon Gutman – ***Morgan Stanley – Analyst***

Thanks, good morning. Following up on some commentary, Craig, you were making about big-ticket, so we know it was very strong and I think you called out appliances, flooring and roofing and that you've always try to gauge the balance of it. I guess for those categories to have been strong in Q3, how should we gauge the sustainability of those? Appliances seems to have been a share gaining category, it's been good for a while, it is probably a big fourth quarter category. Is flooring and roofing more weather dependent or is that more seasonal or is it lasting?

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

Roofing, obviously, can be seasonal depending on what happens. If you get ice and snow you are not really repairing, you might repair but you won't replace a roof. Flooring is less seasonal overall.

Simeon Gutman – ***Morgan Stanley – Analyst***

Okay. And as the follow-up to thinking about, I think Carol you talked about looking at individual markets that there is still some room to go, can you distill a little further, you gave us geographic color by market, can you talk about any performance, I don't know if it is oil markets, rural markets, any disparities on a regional level beneath the geographic data that you provide, better or worse, that you could gauge the overall environment with?

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

Well, in certain geographies like Texas where you may say how are the sales performing there we see double-digit comps in parts of Texas. So Texas is doing very well. I will tell you our stores in North Dakota are negative comping, two stores in North Dakota. So that's a surprise to us, it doesn't matter to the overall company, that's not a surprise. But on balance, as Craig pointed out we have good growth across the country with opportunities for more growth.

Simeon Gutman – ***Morgan Stanley – Analyst***

And the way you look at pent-up demand you've shown us categories that have not reached their full potential. Do you look at your markets that way? Can you share any color about the number of our markets where we don't think the housing market or our business has gotten back to let's say some normalized demand level or has potential to keep going?

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

We do look at it that way. And as we look through peak to trough there are the markets that have not fully recovered.

Simeon Gutman – ***Morgan Stanley – Analyst***

Okay, thanks.

Operator

Matt Fassler, Goldman Sachs.

Matt Fassler – Goldman Sachs – ***Analyst***

Thanks a lot and good morning to you. First question should be a fairly simple one. You gave us the comp for the big-ticket bucket. Can you give us the small ticket and then we can solve for the rest of the business, please?

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

The under 50 was a 1.6% comp.

Matt Fassler – Goldman Sachs – ***Analyst***

Got it. Understood. And then, secondly, you talked about share gains, you spoke about particularly categories like appliances which are more DIY focused. Can you give us a sense of the pace of share gains that you are seeing in pro and perhaps some of the categories that might be standing out from that perspective and your sense, I guess, as part of that as to how the pro market looks today from a growth perspective relative to DIY?

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

I would say that the pro is very strong. One thing we saw this quarter is we have always talked about the high spend pro and the low spend pro. The low spend pro comp was on par with a high spend pro, so that's nice to see, not only geographical breadth but the high and low spend pro are each comping at that stronger rate than consumer. And as we look across departments virtually every department had higher pro spend comp than consumer. So the pro is strong across the business. We continue to be extremely pleased with our lumber and building material business. Our tool business in particular just continues to accelerate and we are taking meaningful share in the tools business.

Matt Fassler – Goldman Sachs – *Analyst*

And presumably we can tie to some degree that migration to pro with the overall strong performance with the bigger ticket baskets for you?

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

Certainly, yes.

Matt Fassler – Goldman Sachs – *Analyst*

Okay, thank you so much for that detail. I appreciate it.

Operator

Dan Binder, Jefferies.

Dan Binder – Jefferies & Co. – *Analyst*

Thanks, a few questions. First, August stood out as a softer month. Was there anything in particular that you would highlight there?

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

It was an extremely warm month.

Dan Binder – Jefferies & Co. – *Analyst*

Okay. And then in the appliance business it looked like the industry as well as you were a little bit more aggressive year over year, and I suspect that may be in part due to what you highlighted earlier in terms of wanting to take share.
But I was curious what your feelings were about the health of the appliance industry given what we've heard from vendors and what you see in your own business. In other words, is it taking higher promotions to drive that comp?

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

Our promotional cadence is almost identical to last year. And we see the strength in our portfolio across all of our brands and very, very strong across the board.

Dan Binder – Jefferies & Co. – *Analyst*

And then lastly on holiday, the holiday business every year that business seems to get bigger and I was just curious how you've ordered for this year? Is it up, are orders up double digit, what are you expecting in terms of the contribution to the fourth quarter?

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

It's a big business and a growing business. It still for the quarter not a determinative business for us but, yes, we bought into that. That's part of our growth in inventory, and we are expecting another great holiday season.

I'd say also on the back of our Halloween & Harvest, we bought into that as well this past year. We're extremely pleased with the performance of that deco holiday segment and looking for to an equally strong Christmas period, as well.

Dan Binder – Jefferies & Co. – *Analyst*

Great, thanks.

Operator

Mike Baker, Deutsche Bank.

Mike Baker – Deutsche Bank – *Analyst*

Thanks. So I just wanted to follow up on the pro, and can you estimate for us what you think your share of the pro-business is compared your share of DIY? And eventually what do you think you could gain in terms of share for the pro-business?

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

So share around the pro is a little bit elusive but, again, we try to triangulate on the number. I think what we've looked at is we are playing now in a $550 billion market with the addition of the MRO for hospitality, institutional and multifamily. We think total share for The Home Depot play somewhere in the 15% range inclusive of all of pro and DIY and services. And we believe that our DIY share is sitting somewhere in the neighborhood of 27% to 28%.

Mike Baker – Deutsche Bank – *Analyst*

Okay. So we back into pro being about 10% given the penetration of –

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

10% at 12% give or take, yes.

Mike Baker – Deutsche Bank – *Analyst*

Okay. Thank you. And then a couple of other follow-ups. Promotional cadence, you said you were relatively similar, but what have you seen from any of your competitors? And particularly on appliances, one of the big vendors had a pretty strong appliance unit but very low dollars because of mix and pricing. So I'm wondering if you are seeing any of your competitors be irrational? Because that's something that I think has impacted you guys in the past when some competitors got a little irrational with appliances.

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

I would say appliance is included but our entire Q4 cadence is identical. Like I can't think of anything that we're meaningfully different from Q4 of last year. I would say broadly across the business in portfolio in categories we are focused on offering an everyday low price to our pro and consumer customers.

Mike Baker – Deutsche Bank – *Analyst*

So that is your offering. You are not seeing anything irrational from competitors, I guess is the question.

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

Time to time folks run promotions that try to drive their business. That's just the nature of the business these days. And we are going to, we see that, we see that with the competition but we are going to work hard to try to remain focused on our everyday value for our customer.

Mike Baker – Deutsche Bank – *Analyst*

Okay, great. Thanks for the color.

Operator

Dennis McGill, Zellman Associates.

Dennis McGill - Zelman & Associates – *Analyst*

Good morning, thank you. Carol, one question on inventory side. I think, obviously, last quarter you mentioned some error in the algorithm and just curious if you could update us there as far as where you guys are on the in-stock?
And then more broadly just how you are thinking about inventory management now and in the future? We've heard a lot of suppliers talk about inventory adjustments, the big customers and curious if you feel that to be somewhat tied to the end market of point-of-sale or if that's more strategy on the distribution side?

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

Well, I will talk about some of the inventory findings. First, our in-stock rates are a tick higher than they were year on year. That's exactly where we want them to be. We bought in for the season. So our inventory is healthy, we are ready for the season. The quality of inventory has never been better. If I look at clearance, in active, e-velocity, we are at the lowest levels in the 21 years that I've been here. So never better in terms of quality. And in terms of where we think the inventory may go we've got a lot of initiatives underway in the supply chain world. And maybe Mark Holifield would comment on the supply chain Sync and so on and so forth.

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

Yes, we are pleased with the results of supply chain Sync. Certainly pleased right now with the state of our inventory. As Carol outlined, a tick higher than last year, well prepared for Q4 and we've increased our JLQs for our pro customers a bit. In terms of Sync we continue to roll that out. The way to think about that, our RDC network handles about half of our cost of goods sold. We are live in two-thirds of our RDCs at this point with about two-thirds of the COGS, the cost of goods sold, dollar volume through there. We will be rolling to the north RDCs here as we go through the next several months. And that will complete the rollout terms of the RDCs. And then we will continue to roll to other vendors as we continue.

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

I think the most important thing as it relates to inventory, obviously, we look for productivity but, first and foremost, is we are looking to continually improve our overall in-stock position and be able to take care of the customers' needs and the quantities that they need.

Dennis McGill - Zelman & Associates – *Analyst*

And then a second question, just as it relates to both Canada and Mexico I guess different impacts going on, but hoping you can maybe speak to the fundamental backdrop in Canada with housing market looking a little bit weaker there, just what

you're seeing as far as your performance, whether that's share gain or maybe we shouldn't be worried about some of the housing metrics. And then in Mexico under the new administration
any thoughts as how it could impact your business with policy or immigration reform, etc.?

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

Let me start with Mexico. Obviously, there have been changes in Mexico over the years. We have been able to drive an unbelievable performance in Mexico through all those changes and we will continue to see us doing that.
We are very pleased with our business in Mexico. The team has done a phenomenal job down there of growing that business and positioning us as the largest home improvement retailer in Mexico. As it relates to Canada, clearly what you've seen in Canada or what we've experienced is in the province of Alberta in the Saskatchewan where more dependent upon energy, clearly we've seen pressure there that we haven't seen in the balance of the country. But the team has worked hard
to offset that pressure and grow the business overall, and we are very pleased with our business in Canada and the team has done an amazing job to offset that pressure in the West.

Dennis McGill - Zelman & Associates – *Analyst*

Thank you guys, good luck.

Operator

Brian Nagel, Oppenheimer.

Brian Nagel – Oppenheimer & Co. – *Analyst*

Hi, good morning. Thanks for taking my questions. First question, and this I know is a really big picture and early, but with the change in administration here in the United States any initial thoughts as to how you are thinking at Home Depot how the shifting political landscape could impact your Company?

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

Our thoughts are our job is to stay focused on our customer, to make sure that we are driving the most convenient, interconnected experience
leveraging all the asset bases that we have and that we are driving value for our customers through great values and through great innovation.
That is our sole focus. It is what we are all about, it is what we need to stay in tune with so that we stay relevant to our customers.

Brian Nagel – Oppenheimer & Co. – *Analyst*

I appreciate that. Secondly, I know there's been other questions on appliances as well, but my question here is it seems as though just watching a wide number of large number of retailers that more and more chains of various sizes are pushing into this business. So with that I guess I'm asking are you seeing increased competition from other retailers pushing into the business? And if so what form is that taking and have you had to change or are you considering changing how you go to market in appliances as a result of that?

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

Yes, there are obviously more folks jumping into this business. But, again, as Ted described we have a very strong appliance business, we are gaining share in the category, we like our model.

Ted Decker - *The Home Depot, Inc. - EVP, Merchandising*
We have not seen an impact from new entrants. And we don't envision any change to our go-to-market strategy on appliances.

Brian Nagel – Oppenheimer & Co. – *Analyst*
Thank you.

Operator

Scot Ciccarelli, RBC Capital Markets.

Scot Ciccarelli – RBC Capital Markets – *Analyst*

Good morning guys. Carol, I wanted to go back to one of your earlier comments regarding market-by-market differences. Yes, we know that some markets haven't necessarily recovered from a home price perspective, but we actually have seen pretty rapid home price appreciation in other markets. And at least in pockets we are starting to hear about some pricing pressure in some of those. So I guess the question is are there some high, let's call it, home appreciation markets where you're starting to see any slowing in big-ticket sales?

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

I actually looked at that this morning. I went to the San Francisco Bay Area and I went to Seattle because those are two markets where you are seeing real home price appreciation. And I went to see are we seeing a slowdown in big-ticket or anything that would cause us to be concerned, and we don't see anything at this point.

Scot Ciccarelli – RBC Capital Markets – *Analyst*

Gotcha. Okay. Then just quickly shifting to gross margin, I know you previously talked about gross margin expansion in the back half of this year. Maybe I just had the cadence a bit wrong, but I guess I would have expected some modest expansion in 3Q. Was there anything else that may have impacted the gross margin that you didn't already cite and has your outlook for 4Q changed at all?

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

No, we were very pleased with our gross margin performance in the third quarter. We expanded by 6 basis points and based on the guidance I've given you, you should expect similar expansion in the fourth quarter.

Scot Ciccarelli – RBC Capital Markets – *Analyst*

Roger that. All right, thanks guys.

Operator

Seth Basham, Wedbush Securities.

Seth Basham – Wedbush Securities – *Analyst*

Thanks a lot and good morning. My question is around trade up and trade down. Have you guys seen any trends in consumers trading up to more expensive products with Interline or trading down for that matter?

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

That's something we watch and have given color on previously. We see a similar trend where our comps are strong across the value line with higher comps in the higher price point goods. And we think that is a lot driven by innovation and just a fabulous product that we are bringing to the market.

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

If you think about the two products and power tools that Ted called out in his comments, those are unbelievable innovations that clearly help drive ticket within the category and expansion of benefits for the customer.

Seth Basham – Wedbush Securities – ***Analyst***

Got it. And in terms of big projects that consumers are doing, are we seeing bigger tickets associated with those projects as they prefer more expensive items to complete them?

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

You can look at our services business and our services business up year on year we exited a few businesses at the end of last year. If you ignore the businesses that you exited our services business, which has an average ticket north of $1,000, grew faster than the Company average in the third quarter.

Seth Basham - Wedbush Securities – Analyst

Great, thank you very much.

Operator

Greg Melich, Evercore ISI.

Greg Melich – Evercore ISI – ***Analyst***

Great, two questions. I think one is just a follow-up, Carol, on Interline in that last comment. So if we look at Interline could you give us the impact on SG&A in the quarter and also just how that business is going? Presumably it is also growing faster than the Company average.

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

So Interline contributed $300 million of growth year on year. The gross margin, obviously, impacted the gross margin. And in terms of EPS we generated a couple of pennies of EPS off of Interline in the quarter.

Greg Melich – Evercore ISI – ***Analyst***

And what did it do into SG&A?

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

It was pressure, it was in the overall guidance that we gave.

Greg Melich – Evercore ISI – ***Analyst***

I guess we will back into that. And EPS was slightly accretive?

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

Yes, about two pennies.

Greg Melich – Evercore ISI – ***Analyst***

My real question sort of ties back to the SG&A. I think you mentioned that given rising wage pressures and other costs that we should go forward thinking about 50% growth of sales into 2017 and perhaps beyond.
How should we think of that? Is it simply a sales are growing 5% that we should assume SG&A dollars grow 2.5%? Or is there a baseline that it grows and then it's 50% of a comp above that or am I thinking about it too much?

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

You are thinking about it too much. Because our largest expense is payroll and we have an activity-based model. And so we have so much opportunity to adjust to the payroll staffing side of our store. So just use 50%. Will it be perfect? No, but it's good enough for modeling purposes.

Greg Melich – Evercore ISI – ***Analyst***

So that's more of just letting us know that the fourth quarter where SG&A really isn't going to grow as a comparison issue we shouldn't use that as
a new trend.

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

Exactly.

Greg Melich – Evercore ISI – ***Analyst***

Got it. And then last if I could sneak one in, the pro side of the business if we were to disaggregate it and think about the buckets that were driving it, I think in the beginning, Craig, you mentioned a few different things.
The new credit offer was last but delivery was focused. Could you give us any highlights there like, Carol, you did on the credit as to how the delivery take-up is doing and how you see the customer changing as they do that?

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

Again we are now rolled out with a new delivery program in about 1,600 stores. And, again, we have seen double-digit growth in deliveries. Now not all of that is incremental. We think roughly 50% of that is incremental sales growth. But clearly some customers are taking up on the offer that might have picked it up before as well. And we anticipated that would happen.

Greg Melich – Evercore ISI – *Analyst*

Great. And how many of your pros do you think have used it?

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

That I don't know.

Greg Melich – Evercore ISI – *Analyst*

Thanks, good luck.

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

We have time for one more question, Catherine.

Operator

Peter Keith, Piper Jaffray.

Peter Keith – Piper Jaffray – *Analyst*

Thanks for letting me in. Great quarter. I was curious on the recent step-up in mortgage rates the last couple of days, if you have any thought on how that may or may not impact your business and maybe even making some comparisons back to the 2013 when we saw another sharp rate increase?

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

So we looked at the affordability index which is over 150%, so that's good news. And then we went back and looked at, okay, historical percentages of household income used for mortgage payments. If you look at the years 1995 through 2000, 22% of homeowner’s income was used for their mortgage payment. It's down now to about 14%. Interest rates could go up to 7%, and no one is suggesting that will happen, but interest rates could go up to 7% and we would be back to about 22% of household income used for mortgage payments. So we've got a long way to go before there's any impact, we think, to our business from rising interest rates.

Peter Keith – Piper Jaffray – *Analyst*

That's interesting. Thank you. Maybe last for me, it's interesting that mix was at gross margin positive. I guess we are not used to seeing that in your business. Could you talk about what happened there and is that something that we might see going forward?

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

We had higher penetration of certain categories that had higher margins not because our retails went up but because we took cost out. I think we've talked to you in the past that we stood up a cost-out team that works with our merchants. We really do try to drive productivity in our cost of goods sold, so it was that dynamic of a higher penetration in categories of cost out that really gave us the margin expansion.

Peter Keith – Piper Jaffray – *Analyst*

Okay, thanks a lot and good luck in the fourth quarter.

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

Thank you everyone today for joining us. We look forward to talking with you in February for our fourth-quarter earnings call. Talk to you then.

Operator

Thank you. Once again, ladies and gentlemen, that does conclude today's conference call. Thank you all again for your participation.