HD – Q4'23 Home Depot Earnings Call
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PRESENTATION

Operator

Greetings, and welcome to The Home Depot Fourth Quarter 2023 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Isabel Janci. Please go ahead.

Isabel Janci - *The Home Depot, Inc. - VP, IR & Treasurer*

Thank you, Christine, and good morning, everyone. Welcome to Home Depot's fourth quarter and fiscal year 2023 earnings call. Joining us on our call today are Ted Decker, Chair, President and CEO; Ann-Marie Campbell, Senior Executive Vice President; Billy Bastek, Executive Vice President of Merchandising; and Richard McPhail, Executive Vice President and Chief Financial Officer.

Following our prepared remarks, the call will be open for questions. Questions will be limited to analysts and investors, and as a reminder, please limit yourself to one question with one follow-up. If we are unable to get to your question during the call, please call our Investor Relations department at 770-384-2387.

Before I turn the call over to Ted, 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 Ted.

Ted Decker - *The Home Depot, Inc. - President & CEO*

Thank you, Isabel, and good morning everyone.

As you'll hear from the team shortly, the fourth quarter of fiscal 2023 was largely in line with our expectations.

For fiscal 2023, sales were $152.7 billion, down 3.0 percent from the prior year. Comp sales declined 3.2 percent versus last year, and our U.S. stores had negative comps of 3.5 percent. Diluted earnings per share were $15.11 compared to $16.69 in the prior year.

After three years of exceptional growth for our business, 2023 was a year of moderation. It was also a year of opportunity. We focused on several operational improvements to strengthen the business, while also staying true to the growth opportunities detailed at our investor conference in June.

As we reflect on 2023, we are better positioned in four key areas. We…

- Invested in our associates, the heartbeat of our company and the stewards of customer service;
- Effectively managed disinflation, while maintaining a strong value proposition for our customers;
- Right-sized our inventory position and increased in-stock and on shelf availability levels;
- And, we reduced fixed costs in the business that were introduced during the pandemic.

As you know, at the beginning of 2023, we announced an approximately $1 billion investment in increased annualized compensation for our front-line hourly associates. This allowed us to improve customer service, position ourselves favorably in the market, attract and retain the most qualified talent, drive greater efficiency and productivity across the business, and improve safety broadly.

We also navigated a unique disinflationary environment. We did this by leveraging our best-in-class cost finance team and merchants to effectively manage cost movements, while also being our customer's advocate for value. And, we believe prices have essentially settled in the marketplace.

After several years of unprecedented sales growth, we entered 2023 with more inventory than we would have preferred. While the products we sell have low obsolescence, our teams worked throughout the year to improve inventory productivity, while delivering the highest in-stock and on-shelf availability rates since the pandemic. Today, we feel very good about our inventory position heading into 2024.

Productivity and efficiency are hallmarks of The Home Depot, and as you heard at our investor conference in June, we announced our commitment to reduce fixed costs by approximately $500 million, to be fully realized in 2024. We've now taken the necessary actions to achieve this cost benefit, which Richard will detail in a moment.

As we look forward to 2024, we remain focused on our strategic opportunities of creating the best interconnected experience, growing our Pro wallet share through our unique ecosystem of capabilities, and building new stores.

In December 2023, we made a strategic acquisition of Construction Resources, a leading distributor of design-oriented surfaces, appliances, and architectural specialty products for Pro contractors focused on renovation, remodeling, and residential home building. This acquisition adds to our robust offering of products and services and allows our complex Pros to easily shop across aesthetic product categories in a showroom setting, which is how they are accustomed to shopping for these types of goods. We are excited to welcome Construction Resources into the Home Depot family.

In 2024, we will continue learning and building out new capabilities for the complex Pro. We are expanding our assortments, fulfilment options, and our outside salesforce; and just recently began piloting trade credit options. In addition, we continue to work on new order management capabilities to better manage complex Pro orders.

For the complex Pro opportunity, this means that by the end of 2024, we will have 17 of our top Pro markets equipped with new fulfillment options, localized product assortment, an expanded salesforce, and enhanced digital capabilities, with trade credit and order management in pilot or development.

What I hope you take away today is how great we feel about our business and how well we are positioning the business for the future. We remain excited about the opportunity to grow our share of a fragmented $950 billion dollar plus market. Our associates and supplier partners have continually demonstrated agility and resilience, and I want to thank them for their hard work and dedication to serving our customers and communities.

And with that, I'd like to turn the call over to Ann.

Ann-Marie Campbell - *The Home Depot, Inc. – Senior EVP*

Thanks Ted and good morning everyone.

I couldn't be more pleased with our operational excellence and the investments we continue to make in the business. As you heard from Ted, we remain focused on our three main strategic opportunities of creating the best interconnected experience, growing our Pro wallet share through our unique ecosystem of capabilities, and building new stores.

As we continue to create the best interconnected experience and remove friction from our customer's shopping journey, one of our biggest areas of opportunity is within our post-sale experience. For the majority of our customers, this process has largely been unchanged for the last 44 years and we have opportunities to improve this experience.

In 2023 we made significant progress taking friction out of our online order management process. Today, we've enhanced our systems to better allow our customers to both modify orders and self-service online returns.

In 2024 we will focus on building more robust capabilities to support an interconnected self-service returns process, where customers will have the ability to start a return online and complete that return via mail or in-store.

We have just begun all of this work in earnest and are very excited about the friction we will remove through this process while realizing significant productivity benefits over the long-term. Through these enhancements and new capabilities in our returns process, we gain efficiencies by reducing transaction time and improving on shelf availability, enabling better inventory management. We also improve customer service by allowing the customer to start and complete their return however they want. As you've heard us say many times, we are focused on making our interconnected experience better and more convenient no matter how our customers choose to engage with us.

As we mentioned at our Investor Conference in June, we plan to open approximately 80 new stores over the next five years. Our current network of over 2,300 stores throughout North America makes The Home Depot the most convenient physical destination for customers to shop for their home improvement products. We have a premier real estate footprint that provides convenience for the customer that we believe is nearly impossible to replicate. And we will continue to build out this footprint in a very strategic way by investing in new stores in areas that have experienced significant population growth or where it makes sense to relieve some pressure on existing high-volume stores.

In fiscal 2023 we opened thirteen new stores: 8 in the U.S. and 5 in Mexico. In the U.S., our 8 new stores were roughly split between stores relieving pressure from higher volume existing stores and stores where we identified voids in new high growth areas. As an example, we are already seeing great results from many of these stores and are particularly pleased with our Mapunapuna store in Honolulu, which allows us to better serve the Honolulu market.

For fiscal 2024, we plan to open approximately 12 new stores.

Beyond our focus on removing friction and growing through new stores, we have a lot of initiatives in 2024 geared at growing our share of wallet with the Pro. My new organization will be focused on better enabling alignment so we can more seamlessly deliver on our unique value proposition for all Pros. When we invest in new assets and capabilities to better serve the complex Pro, this also improves our Pro experience in our stores. For example, more jobsite delivery orders fulfilled from our distribution centers means less congestion in our stores and less time dedicated to picking, packing and staging orders for delivery. This gives our in-store Pro sales associates more time to dedicate to our Pros. Additionally, the ability to fulfill large orders through our distribution network also means that we have more product in-stock and available for sale for those Pros shopping in our stores. These improvements benefit our associates and all of our Pros.

Our investments in these strategic initiatives as well as the investment in our associates has set us up for success. Recall that at the beginning of the year, we announced a significant investment of approximately $1 billion in increased annualized compensation for our frontline, hourly associates. As a result of this investment, we saw what we intended to see…meaningful improvement in our attrition rates; particularly among our most tenured associates, which drove improved customer service, productivity, and safety.

I'm excited to see all of our initiatives gaining traction, and I want to thank our amazing associates for all that they do.

With that, let me turn the call over to Billy.

Billy Bastek - *The Home Depot, Inc. – EVP, Merchandising*

Thank you Ann and good morning everyone.

I want to start by also thanking all of our associates and supplier partners for their ongoing commitment to serving our customers and communities. As you heard from Ted, during the fourth quarter, our sales were largely in line with our expectations, however we did have some unfavorable impacts from weather in January and core commodity deflation. We saw a continuation of a trend that we have been observing throughout the year, with softness in certain big ticket, discretionary type purchases. Our customers continue to take on smaller projects, while still deferring larger projects.

Turning to our department comp performance for the fourth quarter… our building materials and outdoor garden departments posted positive comps and 6 of our remaining 12 merchandising departments posted comps above the company average including appliances, plumbing, tools, paint, indoor garden and hardware.

During the fourth quarter, our comp transactions decreased 2.1 percent and comp average ticket decreased 1.3 percent. However, we continue to see our customers trading up for new and innovative products.

Deflation from core commodity categories negatively impacted our average ticket by 35 basis points during the fourth quarter, driven by deflation in lumber and copper wire. During the fourth quarter we continued to see, on average, a decline in lumber prices relative to a year ago. However, framing and panel lumber pricing experienced the most stable pricing levels during the quarter in some time. As an example, framing lumber started the quarter at approximately $370 dollars per thousand board feet compared to ending the quarter at approximately $395 dollars, representing a change of less than 7 percent.

Big-ticket comp transactions, or those over $1,000 dollars, were down 6.9 percent compared to the fourth quarter of last year. We continued to see softer engagement in big ticket discretionary categories like flooring, countertops and cabinets.

During the fourth quarter, our Pro and DIY customer's performance was relatively in line with one another. While internal and external surveys suggest that Pro backlogs are lower than they were a year ago, they have remained stable and elevated relative to historical norms.

Turning to total company online sales, sales leveraging our digital platforms increased approximately 2 percent compared to the fourth quarter of last year. We continue to enhance our digital customer experience with a number of new capabilities including: an enhanced browsing experience featuring the best sellers in a local market; and new product discovery zones which highlights what's trending based on new and highly rated products. For those customers that transacted with us online during the fourth quarter, nearly half of our online orders were fulfilled through our stores.

During the fourth quarter, we hosted our annual decorative holiday, gift center and black Friday events. We saw strong engagement across all of these events with our decorative holiday event posting a record sales year.

As Ted mentioned, 2023 marked a year of significant progress for inventory management and on-shelf availability, while effectively navigating a disinflationary pricing environment and maintaining our position as the customers' advocate for value. Today, we are in a great position regarding our inventory levels, our in-stocks are the best they have been in a number of years and we are delivering a compelling assortment for our customers home improvement needs.

We are looking forward to the year ahead, particularly with the spring selling season right around the corner, and we have a great lineup of new and innovative products from live goods to outdoor power equipment. We are excited to expand our offering of Pro outdoor tools with the launch of our new cordless battery powered Milwaukee M18 backpack blower and straight shaft trimmer broadening our assortment for the Pro landscaper. And our spring gift center event continues to lean into cordless technology with a wide assortment of products from Ryobi, Milwaukee, Makita, and Dewalt, many of which are exclusive to The Home Depot in the big box retail channel.

We are also excited about our Live Goods Program. Each year our merchants partner with our national and regional growers to provide our customers with new and improved varieties to enhance the overall garden experience. We have made significant investments, in partnership with our growers, to bring new varieties to our customers that are more disease resistant, tolerant to different climates and require less watering. Investing in our relationships with our growers will allow us to continue to drive innovation to meet our customers' needs and improve their shopping experience while building loyalty to the Home Depot.

As we look forward to Spring, we are excited about continuing to provide a broad assortment of best-in-class products that are in-stock and available for our customers when and how they need it.

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

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Thank you, Billy, and good morning everyone.

In the fourth quarter, total sales were $34.8 billion dollars, a decrease of 2.9 percent from last year.

During the fourth quarter, our total company comps were negative 3.5 percent, with comps of negative 2.5 percent in November, positive 1.1 percent in December, and negative 8.5 percent in January. Comps in the U.S. were negative 4.0 percent for the quarter, with comps of negative 2.7 percent in November, positive 0.6 percent in December, and negative 9.1 percent in January. In local currency, Mexico and Canada posted comps above the company average, with Mexico posting positive comps. It is important to note that adjusting for holiday shifts and weather-related impacts in January, monthly comps were relatively consistent across the quarter.

For the year, our sales totaled $152.7 billion dollars, a decrease of 3.0 percent, versus fiscal 2022. For the year, total company comp sales decreased 3.2 percent and U.S. comp sales decreased 3.5 percent.

In the fourth quarter, our gross margin was approximately 33.1 percent, a decrease of 20 basis points from last year.

For the year, our gross margin was approximately 33.4 percent, a decrease of 15 basis points from last year, which was in line with our expectations.

During the fourth quarter, operating expenses as a percentage of sales increased approximately 115 basis points to 21.2 percent compared to the fourth quarter of 2022. Our operating expense performance during the fourth quarter reflects our previously executed compensation increases for hourly associates as well as deleverage from our topline results.

For the year, operating expenses were approximately 19.2 percent of sales, representing an increase of approximately 90 basis points from fiscal 2022.

Our operating margin for the fourth quarter was approximately 11.9 percent, and for the year was approximately 14.2 percent.

Interest and other expense for the fourth quarter increased by $50 million dollars to $458 million dollars.

In the fourth quarter and for fiscal 2023, our effective tax rate was 24.0 percent.

Our diluted earnings per share for the fourth quarter were $2.82, a decrease of 14.5 percent compared to the fourth quarter of 2022. Diluted earnings per share for fiscal 2023 were $15.11, a decrease of 9.5 percent compared to fiscal 2022.

At the end of the quarter, merchandise inventories were $21.0 billion dollars, down $3.9 billion dollars, or approximately 16 percent, versus last year, and inventory turns were 4.3 times, up from 4.2 times from the same period last year.

Moving on to capital allocation…during the fourth quarter, we invested approximately $860 million dollars back into our business in the form of capital expenditures. This brings total capital expenditures for fiscal 2023 to approximately $3.2 billion dollars.

During the year, we opened 13 new stores bringing our store count to 2,335 at the end of fiscal 2023. Retail selling square footage was approximately 242 million square feet and total sales per retail square foot were approximately $605 dollars in fiscal 2023.

Additionally, we invested approximately $1.5 billion dollars on three acquisitions during fiscal 2023, accelerating our strategic initiatives and providing us with better capabilities to serve our customers.

During the year, we paid approximately $8.4 billion dollars of dividends to our shareholders. Today, we announced our Board of Directors increased our quarterly dividend by 7.7 percent to $2.25 per share, which equates to an annual dividend of $9.00 dollars per share.

And finally, during fiscal 2023, we returned approximately $8.0 billion dollars to our shareholders in the form of share repurchases, including $1.5 billion dollars in the fourth quarter.

Computed on the average of beginning and ending long-term debt and equity for the trailing twelve months, return on invested capital was 36.7 percent, compared to 44.6 percent at the end of the fourth quarter of fiscal 2022.

Now I'll comment on our outlook for 2024.

First, let me point out that fiscal 2024 will include a 53rd week, so the fourth quarter of fiscal 2024 will consist of 14 weeks. We will continue to report comps on a 52-week basis, but we will base our overall guidance on 53 weeks.

As you heard from Ted, we feel great about the actions we took in 2023 to position us well heading into 2024. And while there are signs that the economy is on the way towards normalization, the home improvement market still faces headwinds as we look ahead to fiscal 2024. We considered several factors that informed our outlook for fiscal 2024.

On the positive side, we faced a number of pressures in fiscal 2023 that are unlikely to repeat in fiscal 2024. In 2023, we saw four increases in the fed funds rate, a sharp decline in existing home sales and approximately 110 basis points of comp pressure from lumber deflation.

However, we still expect pressures to our business in Fiscal 2024:

- Personal consumption growth as measured by PCE is expected to decelerate compared to 2023
- Our share of PCE also remains slightly elevated relative to 2019 and has been on a glidepath towards 2019 levels
- Higher interest rates at the beginning of 2024 relative to last year, will likely continue to pressure demand for larger projects
- And the effects from pull forward of demand during the pandemic as well as some project deferral could impact demand into 2024

As we consider these influences on home improvement demand, we are planning for a year of continued moderation, but with slightly less pressure to comp sales than what we faced in fiscal 2023.

Our fiscal 2024 outlook is for total sales growth to outpace sales comp, with sales growth of approximately positive 1% percent and comp sales of approximately negative 1% percent compared to fiscal 2023. Total sales growth will benefit from a 53rd week, as well as from the acquisitions we made and the new stores we opened in fiscal 2023 and plan to open in fiscal 2024. We expect the 53rd week will contribute approximately $2.3 billion dollars in sales.

Our Gross Margin is expected to be approximately 33.9 percent, an increase of approximately 50 basis points compared to fiscal 2023. This primarily reflects a lower product and transportation cost environment relative to fiscal 2023 as well as benefits from a portion of the approximately $500 million dollars in reduced fixed costs that we will realize in fiscal 2024

Further, we expect operating margin of approximately 14.1% percent. This reflects deleverage from sales and pressure from targeted incentive compensation as we are overlapping lower incentive compensation paid than planned in 2023. This will be partially offset by the benefits from the approximately $500 million dollars in fixed costs that we will realize in fiscal 2024 in both cost of goods sold and operating expenses.

Our effective tax rate is targeted at approximately 24.5 percent.

We expect net interest expense of approximately $1.8 billion dollars.

Our diluted earnings per share percent growth is targeted to be approximately 1 percent compared to fiscal 2023, with the extra week contributing approximately 30 cents.

We plan to continue investing in our business with capital expenditures of approximately 2 percent of sales on an annual basis. After investing in our business and paying our dividend, it is our intent to return excess cash to shareholders in the form of share repurchases.

We believe that we have positioned ourselves to meet the needs of our customers in any environment. The investments we've made in our business have enabled agility in our operating model. As we look forward, we will continue to invest to strengthen our position with our customers, leverage our scale and low-cost position to drive growth faster than the market and deliver shareholder value.

Thank you for your participation in today's call, and Christine we are now ready for questions.

QUESTION AND ANSWER

Operator

[Operator Instructions] Our first question comes from the line of Simeon Gutman with Morgan Stanley. Please proceed with your question.

Simeon Gutman - *Morgan Stanley, Analyst*

Hey. Good morning, everyone. Can you – my first question is how much of this minus 1% comp view is an industry view plus or minus share gain? I'm assuming plus versus if you look at current purchasing trends and, Richard, you noted some of the – let's say, some of the less headwinds that you noted that you expect to face in 2023.

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Sure. Yes, Simeon. In short, we expect that the macro pressures we called out to point towards low single-digit negative growth for home improvement demand and then for us to outperform the market. And that's how we got to the negative 1% comp guide. And your second...

Simeon Gutman - *Morgan Stanley, Analyst*

I guess, that was the whole part of it. It was how much of it is a macro view versus like a forecast for housing plus market share versus you had less headwinds that you noted in the current year plus you're combining that with how the consumer is behaving.

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Well, it's all taken as a whole. There are several crosscurrents here. Again, we faced macro headwinds albeit at a lesser degree than we faced in 2023. And so again just to quickly tick through them, PCE is expected to decelerate. We still have a slightly – as a market, we have a slightly elevated share of PCE versus 2019. We know that that has gradually receded since 2021. The interest rate environment is still one where while we see our customers have the means to spend, they are taking more of a deferral stance with respect to large project demand. And we believe there was some pull forward of certain spend during the period of 2020 to 2022 that we're working out.

Housing, it's a little hard to tease out. Obviously, home values have held in there. We now see home prices having appreciated by over 46% since 2019. Turnover has dropped sharply over the last two years and that's a headwind, possibly offset by some level of improvement in place. So, we're essentially neutral on housing in the short term.

And so, all of those have an impact on our market. And then as you said, we expect to gain share in any macro environment through our growth initiatives of Pro, the interconnected experience in new stores, and that takes us to our negative 1% comp outlook.

Simeon Gutman - *Morgan Stanley, Analyst*

Fair enough. And then the follow up, can we ask about the shape of the year? You say you lapped lumber deflation in the first part of the year, may be some weather, so that should be better but the second half is in theory post interest-rate cuts and maybe durable to get a little bit better. So, how should we think about it?

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Yes. So, Simeon, lumber was actually a function more of comparison to 2022, in 2023. If you compare the lumber charts, just – I'd encourage you to pull it up, lumber prices were relatively steady across 2023 so we don't really see a material impact to 2024. With respect to 2024, first, we expect a normal seasonal curve for our business so there's really no seasonal shift in how we think about the halves. We anticipate the second half coming in slightly better than the first half with both being negative at least as implied in our guidance. It might help to recall the halves of 2023 were relatively in line with one another.

Simeon Gutman - *Morgan Stanley, Analyst*

Okay. Thank you. Good luck.

Operator

Our next question comes from the line of Zack Fadem with Wells Fargo. Please proceed with your question.

Zack Fadem - *Wells Fargo, Analyst*

Hey. Good morning. So, starting with the underlying comp commentary, curious if you could share some thoughts on Pro versus DIY trends both for the industry as well as your share gain potential. And then any early thoughts on traffic versus ticket?

Ted Decker - *The Home Depot, Inc. - President & CEO*

If you look at Pro versus Consumer, Zach, I mean, for us, they were effectively the same in Q4. Overall industry, don't see that being too terribly much different. I can say within our Pro, in any customer segment that we have, the managed account customer who's engaging in the ecosystem that we're building was the highest performing customer segment in Q4 and throughout 2023. And we would expect that to continue into 2024 as well as we continue to build out the capabilities.

Zack Fadem - ***Wells Fargo, Analyst***

And then you called out that the disinflationary price environment. I'm curious if you could parse that out between commodity deflation and promotional activity. And then as you look to 2024, could you walk through the signs that you're seeing to suggest that we have turned a corner on the disinflation?

Billy Bastek - ***The Home Depot, Inc. – EVP, Merchandising***

Yeah, this is Billy. Thanks for the question. On the commodity piece, that is embedded in our forward-looking guidance that Richard articulated during his prepared remarks, so.

And as it relates to the promotional cadence, we haven't seen any difference if you go back pre-pandemic to the promotional activity. We are in a very normalized environment. We do feel that pricing is kind of settled, as we mentioned earlier. And so from a promotional standpoint cadence, we don't see any differentiation than, like I said, what we lived through prior to the pandemic. So, very consistent. We really are in a solid marketplace as it relates to that and look forward to 2024.

Zack Fadem - ***Wells Fargo, Analyst***

Thanks for the time.

Operator

Our next question comes from the line of Chris Horvers with JP Morgan. Please proceed with your question.

Chris Horvers – ***JP Morgan, Analyst***

Thanks. Good morning, everybody. So, I was curious as you think about the share of wallet, what did you learn over the holiday season? Are there any signs of life that you're seeing? You mentioned outdoor garden. I'm assuming maybe that's Christmas trees and Christmas decor? Is there any signs of life that maybe the smaller-ticket soft lines stuff that is starting to show or more decor items starting to show some signs of life? Did you see anything in appliances or on the bigger-ticket side?

Ted Decker - ***The Home Depot, Inc. - President & CEO***

No, hey, Chris. It's Ted. We saw great signs of life. There's loads of life in the sector. I mean, we're working through some macro factors, as Richard articulated. But the consumer is healthy and the consumer is engaged. They're just engaged at this point in smaller projects.

And you called out a number of categories that we had terrific engagement in Q4. Our Deco Holiday program was just an exceptional performer. The merchants there just keep taking that to the next level. We know we took a tremendous amount of share in Deco Holiday as the customer responds to our offering. Our gift center lineup with the brands we have and the values that Billy and team put in the marketplace had a tremendous response.

As you said, Deco Holiday in live goods did extremely well. Things like totes, I mean, we sold record units of totes in Q4 as people responded to our Storage event. So, we still have tremendous traffic, pure volume of traffic and engagement. Again, it's just that bigger ticket. Although as an aside on bigger ticket, appliances was one of our better relative performers. And I think a lot of that has to do with our service levels as we're integrating the Temco acquisition and the percentage of our deliveries that they're now handling and the service level scores and on-time and complete that they're providing our customers, we think that's a big piece of the momentum behind our appliance business as well as the strength of our online shopping experience for major appliances.

Chris Horvers – *JP Morgan, Analyst*

And then as a follow up, can you talk about what drove the gross margin decline here in the fourth quarter? You mentioned the expansion here coming in 2024. And then separately just on the SG&A side, you did have a, I think, sizable legal gain in the first quarter of last year. Is that something that will have an effect on 2024 overall? Thank you.

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Sure. Hi, Chris. It's Richard. So, first on fourth quarter gross margin. I'd say, our gross margin, first of all, is in line with our expectations for the year. For the full year and in the quarter, we saw some pull forward of pressure from pricing actions ahead of cost decreases. The good news is you now see those at current levels, and Billy mentioned we're really at kind of a settled point right now in retails and in cost. As we began to work through inventory layers, you now see the impact of those cost decreases that we took earlier in the year coming through in 2024. And that's the major driver behind the gross margin expansion that we've guided to.

On the settlement that you called out, I appreciate the question. It's important to note that there is some geography noise in year-over-year comparisons driven by that settlement. So, just for everyone's recollection, we had a significant settlement in Q1 of 2023 that was a benefit to operating expense.

Now as we said we would do, we fully offset that benefit with short-term costs in 2023 that set us up to lower our cost base going forward. Those short-term costs were mostly incurred in costs of goods sold including some actions taken to optimize inventory levels. So, that settlement geography and the cost that offset it create a more favorable comparison in cost of goods sold and a less favorable comparison in OpEx on a year-over-year basis. But obviously, the two offset each other and it's a geography shift.

Chris Horvers – *JP Morgan, Analyst*

Thanks so much. Have a great spring.

Operator

Our next question comes from the line of Scot Ciccarelli with Truist. Please proceed with your question.

Scot Ciccarelli - *Truist, Analyst*

Good morning, guys. Thanks for the time. Within your comp guide, can you help us understand how you guys are modeling any benefit or accretion from your complex pro buildout, just so we can better understand the thought process around it? And just as a sidebar, can you also tell us how big of a margin drag you expect the incentive comp swing to be in 2024? Thanks.

Ted Decker - ***The Home Depot, Inc. - President & CEO***

On the complex pro, I mean, clearly, the improvement's there and the expectation that the managed account engaging in those capabilities will be the strongest performing customer segment. That's embedded in the guidance of comp sales in overall sales.

Richard McPhail - ***The Home Depot, Inc. - EVP & CFO***

And on the drag from lower incentive bonus in 2023, really, the largest and most meaningful driver of deleverage, as you know, our OpEx levers or delevers as a function of sales growth. So, the largest driver of that is simply sales deleverage as operating cost inflation remains higher than sales growth. To a lesser extent we see deleverage from the incentive compensation year-over-year.

Scot Ciccarelli - ***Truist, Analyst***

Okay. Can I just ask a follow up on that? So just so I can understand that, yes, I understand the managed accounts are kind of the fastest growing. But like are you guys able to kind of disaggregate, let's call it the typical engagement you have with those accounts versus the expanded capabilities you're providing in certain markets? Or is it just too difficult to kind of separate those?

Ted Decker - ***The Home Depot, Inc. - President & CEO***

Oh, no. We can absolutely. And we disaggregate at every level you can imagine. We're just not going to share all that detail, as you can imagine.

Scot Ciccarelli - ***Truist, Analyst***

Okay. Fair enough. Thank you, guys.

Operator

Our next question comes from the line of Chuck Grom with Gordon Haskett. Please proceed with your question.

Chuck Grom - ***Gordon Haskett, Analyst***

Hey, thanks. Just bigger picture, curious what you guys are monitoring across regions or product categories to suggest that demand for the home improvement category from a unit volume perspective is starting to bottom here as we look out over the next couple of years.

Richard McPhail - ***The Home Depot, Inc. - EVP & CFO***

Well, just to hit it on the most fine point here, really the last three quarters we've seen kind of the most stability. And I'd say three-quarters ago we saw a marked recovery in transactions and we think about that as a proxy for units but units followed similarly. Over the last three quarters, we've seen nice stability and as we said before, we define a healthy home improvement market is one where ticket and transaction are both positive. What we have seen on the good side here is the ticket and transaction have begun to converge and in fact have sort of really much more tightly converged over the last three-quarters.

They are still both negative for the quarter but that's really just reflective of the macro pressure that continues. From a geographic perspective, we aren't really necessarily able to tease out differences in recovery on transactions or units is more of a national dynamic.

Chuck Grom - *Gordon Haskett, Analyst*

Okay. Great. And then one for you, Richard, just on how should we think about the sensitivity of operating margins in fiscal 2024 to every point of comp? Hypothetically, you guys are being a little bit conservative on the down 1%. Just trying to think about how the model could respond.

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Sure. The basics are, you can imagine with no management intervention, the natural rule of leverage or deleverage is about 10 basis points per point of comp, up or down.

Chuck Grom - *Gordon Haskett, Analyst*

Okay. Great. Thank you. Good luck.

Operator

Our next question comes from the line of Michael Lasser with UBS. Please proceed with your question.

Michael Lasser - *UBS, Analyst*

Good morning. Thank you so much for taking my question. As we look back to the last couple of downturns in home improvement, there was a pretty robust recovery in the subsequent years after a few periods of negative comps. Are you seeing any evidence or signs that this recovery whenever it happened would be different?

Ted Decker - *The Home Depot, Inc. - President & CEO*

Hi, Michael. We don't see why it would be different. I mean if anything, the underpinning of this market segment remains incredibly strong. When I step back and look at the macro, when you look at the influences that we watch most closely, home price appreciation up 45-odd-percent. Home equity is up closer to 70%. That equity level which is $10 trillion, $12 trillion increase since the pandemic, has not been tapped. And in fact, HELOC and cash-out refis are at multiple years low right now as interest rates went up over the last two years.

So you have tremendous potential in an untapped balance sheet and equity position in homes. We talk about the age of homes. Now, well over 50% are over 40 years old. People are still working from home more than they were certainly pre-pandemic, so usage in homes. The fundamental shortage of homes, I've seen anywhere between 2 million and 6 million units short, and on a near-term even forecast for 2024 we'll build 200,000 odd units less than demand. So you're not even beginning to make up for that shortage in the near term.

So you look at all those factors, Millennials becoming – a year or so away of becoming the single biggest source of customer segment spend in our space. They are prime household formation and homeownership ages. So I look at all those and say the huge opportunity and we mentioned this before but the pandemic in a sense is a bit like a giant hurricane. Right? I mean we had tremendous demand and growth in the segment followed by a couple periods of moderation following that build-up. But as we watched every hurricane market after you go through that cycle, it's as strong as ever.

So with that backdrop of fundamental macros and the overall pandemic playing out over a five-year period like a giant national storm, we have every reason to be extremely optimistic about the future. And that's why we've made the comments today about how happy we are of what we accomplished. The management team here and the store associates and store leadership and supply chain just did such a great job level setting this business following that sort of pandemic storm.

And we couldn't feel better about how we're positioned from an operational point of view, and then we're sticking with all the strategic investments. Our eyes are still on the prize of the best interconnected shopping experience, building out the pro ecosystem for complex pros, and then having such confidence in our model to start a reasonably meaningful store build program. So we feel really, really good, Michael. Thanks for the question.

Michael Lasser - *UBS, Analyst*

Very helpful, Ted. If I could just add one more question. It's on Richard's comment about the rule of thumb of 10 basis points of margin expansion for every 1 point of comp. Understanding that this is theoretical, does that move in a linear fashion, meaning if you get back to the trajectory of mid single-digit comps eventually, that you would see a better-than trend rate of margin expansion at the higher the growth rate? And there was also a comment that that rule of thumb would be outside of actions that would be taken. So can you discuss what actions might be taken to bend that curve on the upside over time? Thank you very much.

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Thanks, Michael. Well, first, I'd certainly want to center you back to the comments we made at the investor conference in June where we call out a base case once we returned to market normalization, a base case of 3% to 4% sales growth, flat gross margin, an assumption of operating expense and operating margin leverage and growth, and EPS growth of mid to high single-digit percentages.

Within that, obviously, is sort of an implied leverage per comp point on our OpEx. I'm giving you a, what I would call, a loose rule of thumb. It would apply for the most part to our sort of business model today. It certainly applied in the past and how we're expecting it to apply loosely in the future. Embedded in that is a normal rate of productivity and efficiency that our teams deliver every single year.

I mean, underneath all this guidance in our results for 2023, which we were so pleased with, is an enormous amount of work on behalf of our team. You think about the efficiency in our supply chain. You think about the efficiencies that our merchants bring every year in product costs.

Of particular note, the productivity in our stores with some of the tools that are unleashing the power of AI and putting that in the hands of our associates, those are standard fare for us. They feed into what I would call normal operating leverage for The Home Depot. And it's something that we've come to expect of ourselves. So that's a long way of saying we always intend to lever OpEx at a certain point of sales growth. And I would stick with the basic rule of thumb; it may be higher, it may be slightly lower in some periods from time-to-time.

On the question about what actions there may be, well, we always operate with a degree of financial flexibility in the P&L, although I would tell you that we did our very best. And I think we accomplished our objective of reducing fixed costs towards the end of 2023 that had built up during the pandemic, hence the $500 million in cost savings implied in our guide. There are always levers. We have to determine what environment we're operating in before we decide what levers to pull. And so, for now we provided what we would call our central case for 2024, but we're going to manage the business with the best interests of our long-term shareholders in mind.

Michael Lasser - *UBS, Analyst*

Thank you very much, and good luck.

Operator

Our next question comes from the line of Seth Sigman with Barclays. Please proceed with your question.

Seth Sigman - *Barclays, Analyst*

Hey. Good morning, everyone. I wanted to follow up on macro and then margins. Just on the macro side, you gave us a number of the factors that are built-in here. I guess the real question is, what are the conditions needed for comps to actually get back to positive? Is it as simple as fully digesting the two years of lower housing turnover and that will happen at some point through this year? I guess ultimately, can you return to growth without existing home sales improving?

Ted Decker - *The Home Depot, Inc. - President & CEO*

Oh, absolutely. I mean, as we've said for the longest time, I mean home turnover is a base of home improvement demand, but it's been pretty steady if you look at 4.5-odd-percent of housing stock as a multiyear percentage of turnover and that equates to 5-ish million units.

The reason we're calling out that as a factor in these last two years is the dramatic decrease, and there's definitely a understanding that there is an improvement-in-place cycle if you don't move and you stay in your house. But there's a lag effect, and arguably, that lag effect is a bit longer this time because of the interest rate environment and people are just being conservative of when they kick off a larger home improvement project in a home that they're going to ultimately stay in for a longer period of time.

So that's the dynamic of housing turnover. We think that plays out. We're literally at a 40-year low in turnover. Don't see that going lower, so you're going to cycle through that kind of acute two-year pressure. And then do we get back to growth? Absolutely. I'd say we have a neutral look on housing for 2024. We don't think there's incremental pressure, nor do we think that we're quite ready for a hockey stick recovery.

Richard's been talking for some time on the Fed's stance of higher for longer. I think now we have an appreciation that longer is going to go through the first half of this year, so even a lowering cycle in the back half, there's some timing effect to get mortgages, move homes, take a HELOC loan out, et cetera, to get a bigger project going.

So that's why we're kind of calling for a slighter moderation to continue into 2024. But as we said that the back half is marginally stronger and we think all the macros line up for a return to normalcy following that and with the capabilities that we're building, we're taking share today with x-percent of these capabilities complete. Super optimistic about how we're hitting the ground running as we continue to build going into a stronger market and the share gain opportunity.

Seth Sigman - *Barclays, Analyst*

Okay. Thank you for that. Just one follow up. Richard, you gave us a bunch of sensitivity numbers around EBIT margins. I guess more specifically on SG&A for this year, I realize there's a number of moving pieces that come back, but can you give us a feel for what base underlying SG&A growth should look like this year? I think the headline guidance is around 4% growth, but maybe what is it excluding incentive comp and some of the costs that you're lapping with the benefits that you're lapping, just so we can think about that? Thanks.

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Yeah, I tell you, the best way to look at this is that we are now – our P&L provides you with an appropriate jumping off point for your models. There's a lot of noise in operating expense. You think about the geography of the settlement in Q1, you think about the geography of costs that we incurred, then you think about the geography of the $500 million in cost out, two-thirds of which will be realized in OpEx, one-third of which will be realized in cost of goods sold, and you just have a lot of noise.

Again, the main driver of operating expense growth is going to be just that inflation in our base of operating expenses. And we think that if you look at our gross margin and our operating margin guide, these offer you the appropriate jumping-off points for your modeling.

Seth Sigman - *Barclays, Analyst*

Got it. All right. Thank you. Good luck.

Isabel Janci - *The Home Depot, Inc. - VP, IR & Treasurer*

Christine, we have time for one more question.

Operator

Thank you. Our final question comes from the line of Steven Forbes with Guggenheim. Please proceed with your question.

Steven Forbes - *Guggenheim, Analyst*

Good morning, everyone. I'll keep it to one just to end the call here. But wanted to follow up on the complex pro, Ted, appreciate the comments in your prepared remarks around trade credit being piloted. But curious if you could maybe expand on some early learnings around those newer features being launched as we think through what the sort of managed account customer can contribute to growth over the coming years here.

Ann-Marie Campbell - ***The Home Depot, Inc. – Senior EVP***

Yeah. I'll kick that off. Thanks, Ted. First of all, we're in the early stages. And just a reminder as well, HD Supply does trade credit today. So as we architect our program, there's a lot of learnings there. But what, for me, Chip is in the room and, Chip, you have a lot of experience here with trade credit and his experience is helping us also form some of the intricacies of how we think about it. So I'll turn it over to Chip.

Chip Devine - ***The Home Depot, Inc. – SVP, Outside Sales***

Yeah. Thanks, Steven. Trade credit is definitely a necessary capability that we're building really focused on that complex project. So as we invest in our pros and our capabilities to be able to service their larger jobs, trade credit is definitely necessary. So we're in early days as Ann mentioned piloting a number of different customers but plan to grow and expand that through the next couple of quarters as we automate that into our selling system as well.

Steven Forbes - ***Guggenheim, Analyst***

Thank you.

Operator

Ms. Janci, I would now like to turn the floor back over to you for closing comments.

Isabel Janci - ***The Home Depot, Inc. - VP, IR & Treasurer***

Thank you, Christine, and thank you everyone for joining us today. We look forward to speaking with you on our first quarter earnings call in May.

Operator

Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.