HD – Q1'18 Home Depot Earnings Call
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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Home Depot Q1 2018 Earnings Conference Call. Today's conference is being recorded.

[Operator Instructions]

At this time, I'd like to turn the conference over to Ms. Isabel Janci, Vice President Investor Relations. Please go ahead, ma'am.

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

Thank you, Katherine, 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 questions. Questions will be limited to analysts and investors. (Operator Instructions) If we are unable to get your question during the call, please call our investor relations 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 also will 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, Isabel, and good morning everyone.

Sales for the first quarter were $24.9 billion, up 4.4 percent from last year. Comp sales were up 4.2 percent from last year, with U.S. comps of positive 3.9 percent. Diluted earnings per share were $2.08 in the first quarter.

We are pleased with our performance in the first quarter and the fundamentals of our business remain solid. As Ted will detail, excluding weather-impacted categories, our Pro and core interior project business remained strong in the quarter and we saw healthy growth in maintenance and repair categories.

From a geographic perspective, weather impacts can be seen in the variability of performance across Canada, our three U.S. divisions and nineteen regions. Our largest division is the Northern division, which posted flat comps due to weakness in our seasonal categories. The Southern and Western divisions saw relatively better weather trends and comp'ed above the company average.

On the international front, Canada posted a slightly negative comp in local currency, while Mexico posted positive comps in local currency.

You've heard us talk about the bathtub effect based on when spring breaks, where weak seasonal sales in the first quarter are counter balanced by strength in the second quarter. We expect that effect to be true this year. And over the last few weeks, as spring has finally arrived throughout the U.S. and Canada, we're seeing strong customer demand.

Part of the strength we saw in the business can be attributed to the health of our Pro customer, as Pro sales once again outpaced DIY sales in the quarter. Investments aimed at deepening our relationships with our Pro customers are yielding increased engagement, which translates to incremental spend. While still early, the combination of enhanced associate tools in the store and expanded delivery capabilities are gaining traction with the Pros. In delivery for example, we've augmented our 2-hour and 4-hour delivery window options with same day car and van delivery in select markets. These efforts helped drive double-digit delivered sales growth in the quarter.

Our interconnected retail strategy continues to resonate with our customers. Online traffic growth was healthy and first quarter online sales grew approximately 20 percent from the first quarter of 2017. During the quarter, we began to launch the customer's ability to attach install services when they buy certain products online in select markets. For example, in certain markets if you purchase a faucet online and want to include the installation of the faucet in your purchase, we now enable this experience. We continue to invest in the interconnected shopping experience and see a positive response from our customers in the form of improved customer satisfaction scores, better conversion and increased sales.

As we continue to make the shopping experience more convenient for our customers, another area of focus and differentiation is our supply chain. The flexibility of our supply chain is a competitive advantage, particularly when unpredictable weather results in spiky demand patterns. In stock levels are at record highs as our shelves are fully stocked with the products our customers need to get their projects done.

Let me touch briefly on our long term strategic priorities. You will recall that at our Investor Conference in December we outlined our commitment to an accelerated investment plan to create the One Home Depot experience for our customers. I'm pleased to report that our key initiatives are on track. We implemented our enhanced wayfinding sign and store refresh package in nearly 250 stores during the quarter and intend to pilot our first of our new supply chain facilities starting this summer. It is still early days, but we remain very excited about the work and opportunities ahead as we are focused on enhancing the customer experience by investing in our business and in our associates.

Our associates consistently execute. A delay in the spring selling season is not without its challenges, but given the company-wide alignment and coordination of our store teams, merchants, vendor partners and supply chain, coupled with a favorable housing backdrop, we are poised to deliver a strong 2018. I'd like to close by thanking our associates for their dedication, hard work and commitment to our customers.

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

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

Thanks Craig and good morning everyone.

As you heard from Craig, we are pleased with our performance in the quarter. Excluding our seasonal business, sales exceeded our expectations. We saw significant strength in our Pro business, interior projects, and maintenance and repair categories.

The extreme winter weather in the quarter had a negative impact on our garden categories, which historically represent around 15 to 20 percent of our first quarter sales. Our garden departments had negative comps in the quarter, driven by softness in chemicals, fertilizer, mulch, and live goods, just to name a few.

Looking at our departments, appliances, electrical, and lumber had double-digit comps in the quarter. Lighting and our garden departments were negative, with lighting comps a reflection of LED price deflation. All other merchandising departments were at or above the company average.

In the first quarter, comp average ticket increased 5.8 percent, and comp transactions decreased 1.5 percent. If we exclude our garden business, we saw positive comp transaction growth. Commodity price inflation in lumber, building materials, and copper positively impacted average ticket growth by approximately 111 basis points. Foreign exchange rates also positively impacted average ticket growth by approximately 41 basis points.

While cold and wet weather impacted some outdoor related projects, this didn’t prevent our customers from completing a variety of interior projects. Categories like interior doors, bath fixtures, storage and organization, interior paint, door locks, ceiling fans, and window treatments all had comps above the company average. Core maintenance and repair categories also performed well during the quarter, with strong results in safety and security, water heaters, plumbing repair, pipe and fittings, and air circulation.

As you heard from Craig, in the first quarter, we saw continued traction with our Pro. Pro-heavy categories like lumber, gypsum, insulation, pneumatics, wiring devices, and flooring tools all had comps above the company average. In addition, we are building engagement and enabling our associates to target specific customers, which is driving expansion of categories and services sold. In Interline Brands alone, we saw sales growth ahead of the company average.

We also saw a healthy customer appetite for big-ticket projects. Big-ticket sales in the first quarter, or transactions over $900, were up 10 percent. The increase in big-ticket sales was driven in part by strength in vinyl plank flooring, appliances, and various lumber and building material categories.

In the first quarter, we hosted our President’s Day and Spring Black Friday events. Our stores did a fantastic job executing these events, and our customers responded. During the event, we saw great results in several tool categories and cleaning.

One of our core strategies as merchants is to balance the art and science of retail, both in store and online. Over the last year, we made several improvements to our interconnected shopping experience, including better product content, a refreshed mobile experience, improved inventory visibility, and faster checkout. These investments have helped drive a more seamless, frictionless customer experience, and conversion rates in the first quarter increased more than 10 percent year over year across all devices.

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

Just in time for the warmer weather, we are excited to introduce a fantastic new innovative product in our outdoor garden category. We have partnered with Syngenta and Fernlea to bring our new Rio Dipladenia plants to market. These plants are low maintenance, drought tolerant, and have reoccurring blooms throughout the growing season. Rio is available in all of our U.S. stores and is a big-box exclusive to The Home Depot.

In addition, we are very happy to announce the extension of our PPG partnership with the launch of Olympic exterior stains. With this launch, Olympic brings 80 years of trust and brand recognition into our stores. This broadens our assortment in our paint department, providing customers choice with a strong lineup of products across the category.

We are also thrilled about new product offerings across all of our categories and our upcoming events. During the second quarter, we will host our Memorial Day, Father's Day, and Fourth of July events, where we will be offering more great values and special buys for our customers.

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 good morning everyone.

Before we discuss our first quarter results, I want to mention a change in our accounting policy. During the first quarter, we adopted ASU number 2014-09, which pertains to revenue recognition. This standard changes the way we account for certain items related to our private label credit card and gift card programs. While the new standard changes the geography of certain items on our income statement, it has no impact on operating profit. Looking at our first quarter results, the change in accounting caused a $131 million increase to gross profit and a corresponding $131 million increase to operating expenses. Note that the $131 million increase in gross profit was driven by a $33 million net increase in sales and a $98 million decrease in cost of goods sold. While we did not recast our historical financial statements to reflect this accounting change, included in today's press release is a quarterly pro-forma view that shows the impact of the accounting standard as if it had been in place during fiscal 2017.

With that, let's move on to our first quarter results…

In the first quarter, total sales were $24.9 billion, an increase of 4.4 percent from last year. Versus last year, a weaker U.S. dollar positively impacted total sales growth by approximately $104 million or 0.4 percent.

Our total company comps were positive 4.2 percent for the quarter, with positive comps of 5.6 percent in February, 5.9 percent in March, and 2.2 percent in April. Comps in the U.S. were positive 3.9 percent for the quarter, with positive comps of 5.1 percent in February, 5.5 percent in March, and 2.0 percent in April. As you may have personally experienced, April was one of the coldest and snowy-est months in more than twenty years.

In the first quarter, our gross margin was 34.5 percent, an increase of 40 basis points from last year. The increase in our gross margin year over year reflects the following factors:

- First, we experienced $131 million or 48 basis points of gross margin expansion due to the new accounting standard;
- Second, we experienced 14 basis points of gross margin expansion due to changes in mix and the gross margin benefit of recent acquisitions.
- Finally, we experienced 22 basis points of gross margin contraction due to higher shrink and higher transportation costs in our supply chain than what we experienced last year.

In the first quarter, operating expense as a percent of sales increased by 87 basis points to 21.0 percent. Our operating expense reflects the impact of the new accounting standard, the impact of the strategic investment plan we laid out at our December Investor Conference and ongoing expense control. Specifically,

- The new accounting standard resulted in a $131 million increase in our operating expenses and caused 50 basis points of operating expense deleverage.

- Expenses related to our strategic investment plan resulted in approximately 56 basis points of operating expense deleverage.
- Finally, we drove 19 basis points of expense leverage due to ongoing productivity actions in the core business.

Our operating margin for the first quarter was 13.6 percent, a decrease of 47 basis points from last year.

For the quarter, interest and other expense decreased by $2 million to $239 million and our effective tax rate was 23.5 percent compared to 35.2 percent in the first quarter of fiscal 2017. The decrease in our effective tax rate reflects, for the most part, the benefit of tax reform. For the year, we expect our effective tax rate to be approximately 26 percent.

Our diluted earnings per share for the first quarter were $2.08, an increase of 24.6 percent from last year.

Moving on to some additional highlights…

During the quarter, we opened one new store in Stamford, Connecticut for an ending store count of 2,285. Selling square footage at the end of the quarter was 238 million square feet.

Total sales per square foot for the first quarter were $412, up 4.5 percent from last year.

At the end of the quarter, merchandise inventories were $14.4 billion, up 6 percent from last year. Inventory turns were 4.9 times, up slightly from last year. While spring was a reluctant bride, she has arrived and our stores have the inventory necessary to meet demand, which is a good thing, as month to date, for the company, our May comp sales are double digit positive.

Moving on to capital allocation…

In the first quarter, we repurchased $1 billion, or approximately 4.7 million shares, of outstanding stock. As of today, we are targeting $4 billion of share repurchases for fiscal 2018.

Computed on the average of beginning and ending long-term debt and equity for the trailing twelve months, return on invested capital was approximately 36 percent, 370 basis points higher than the first quarter of fiscal 2017.

As we look to the remainder of the year, we are encouraged by what we are seeing in housing and the broader economic environment. The U.S. economy is strong and housing fundamentals continue to be supportive of our business. Unemployment is the lowest it has been since 2000; wages are increasing; home prices are appreciating… buoyed by a housing shortage in the U.S. And while interest rates are rising, this is indicative of a strong economy. At these levels we do not expect interest rates to lead to a slowdown in customer desires or demand.

That's why today, we are reaffirming the sales and earnings-per-share growth guidance that we laid out on our fourth quarter earnings call, adjusting certain items solely for the change in accounting standard. Remember that we guide off of GAAP. The new accounting standard will not affect our earnings per share guidance, but it will impact sales growth and the gross margin and expense growth factor guidance we gave at the beginning of the year.

- Recall that fiscal 2018 will include a 53rd week, so the fourth quarter of fiscal 2018 will consist of 14 weeks.
- For fiscal 2018, we now expect sales to increase by approximately 6.7 percent, with positive comps, as calculated on a 52-week basis, of approximately 5 percent.

- Reflecting the new accounting standard, we now expect our 2018 gross margin to increase by approximately 45 basis points.
- Also reflecting the new accounting standard, we now expect our 2018 operating expenses to grow at approximately 144 percent of our sales growth rate.
- For earnings per share, we expect fiscal 2018 diluted earnings per share to grow approximately 28 percent to $9.31.

I also want to take a brief moment to comment on our long-term financial targets. The new accounting standard does not change our sales growth or operating margin targets for fiscal 2020. Because the accounting change did affect the geography of certain items on the income statement, we have posted an update to our December investor conference materials on our website to assist you with your modeling.

With that, I would like to thank you for your participation in today's call, and Katherine, we are now ready for questions.

QUESTION AND ANSWER

Operator

(Operator Instructions) We'll hear first from Simeon Gutman with Morgan Stanley.

Simeon Gutman - *Morgan Stanley - Analyst*

My first question is all about weather, and it's got a couple parts. Can you clarify, you said garden was negative. Is April the largest month for garden? And then you also mentioned that Northern is your biggest division. If we assume it's, let's say, 40 percent, I think that would imply Southern, Western would be north of likes 6 percent, 6.5 percent. Is that fair?

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

So in terms of garden, April is not necessarily the biggest month in garden generally. That is May. And we actually don't break out the divisional numbers. But Northern division is our largest division.

Simeon Gutman - *Morgan Stanley - Analyst*

Okay. And maybe just a follow-up. Were the remaining divisions, I guess, Southern and Western, were those trajectory similar? Or were there a big discrepancy between them? And then have their quarter-to-date trends held up? I'm assuming Northern is the one that's been broken -- that's breaking out, but has Southern and Western stayed the same or strengthened?

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

Actually, all areas are breaking out with this change in the weather.

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

We're so pleased with the performance across our geographies. And if you look at the performance in the first quarter, the Southern division had a slightly higher comp than the Western division. But remember, the Southern division has some hurricane related sales in it. So if you normalize for hurricanes, the divisions performed pretty much the way they should have performed. It was really in the north and it come back and the whole business is coming back.

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

Okay. And my follow-up question. I think the issue that the market is contemplating here is the cycle question versus what the weather is doing. And so I don't know how you look at it, but if there is something that's slowing that's more than weather and it doesn't seem like that's the case. I guess, how obvious are these signals and how much lead time do you think you have to be able to see them?

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

I mean, first of all, this clearly is really a garden story for us. The miss in terms of garden was significant against what we planned.

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

And Craig, maybe we could just quantify that for you. If you back out the gardens, our comp for the quarter would have been 6.5 percent.

Operator

And our next question comes from Michael Lasser with UBS.

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

So of that 230 basis point impact from the weather, is that a net number, so that's net of the hurricane benefit? And what percentage of that - of those sales do you expect to recoup in the second quarter?

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

The storm-affected [hurricanes] sales were roughly 135 basis point impact. And we actually expect to capture the majority of those [garden] sales and as we're seeing that happen in May.

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

And my second question is on the initiatives that you outlined. Both the 200 stores that you touched with the new signage package, what comp are you seeing those stores produce above and beyond the corporate average? And then as part of that, can you also touch on your Pro delivery initiatives? Is that helping you more with existing customers or customers who really haven't done business with in the past?

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

So let me of touch on the store a minute here and then Mark Holifield is here and can speak to the delivery. 250 stores that we implemented is signing and refresh packaging. We're obviously just completing those. We did that investment for our stores over a couple of year period or doing that because of the pilots that we ran previous to that. And so we've built that lift into our guidance. And that's something that we're rolling here over the next 2 years across all the stores.

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

And Craig, on the new delivery that's out there, the car and van delivery, that's really driving sales across of the range. We have a lot of Buy Online, Deliver From Store customers who are trying out the car and van delivery. And our Pro customers, our existing Pro customers and new customers are using the two and four hour windows.

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

So our map isn't perfect, but our modeling would suggest that the majority of these delivered sales are incremental.

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

Incremental for customers that you're already doing business with or more so attracting customers who you both?

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

It's both.

Operator

We'll continue on to Zach Fadem with Wells Fargo.

Zach Fadem - ***Wells Fargo Securities - Analyst***

Could you talk a little bit about the competitive environment in the paint category? Have you started to see any step change there in terms of promotions? Any thoughts on what you think the key drivers are for you to maintain and win share the category this year?

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

Sure, I would say that the paint promotional environment is certainly for us, it's the exact same year-over-year, we're not seeing any more promotion out of others in the marketplace either. We are very happy with our paint performance. Our comp was at the company average and we saw the strongest interior paint comp gallon performance we've seen in a long time. So we're happy with our brands. We have the best brand with Behr in the marketplace. We're thrilled with our expansion of PPG, and Ann and team are doing a fantastic job in selling them in stores.

Zach Fadem - ***Wells Fargo Securities - Analyst***

Got it. And to follow up, as input costs for items like lumber and building materials continue to grind higher. First of all, what are your expectations there for the year? And is there any concern in your mind on your ability to pass along the higher prices to customers in this environment?

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

Well, the 2 areas we've seen the largest costs request are in clear commodities. So looking at lumber and copper, for example. Those generally, the market passes on. Most of those products are priced weekly. And well-known pricing indexes in the market tends to follow that. So we've had no problem passing that on. I will say lumber and panel prices are at historic highs. We don't see that abating at all. We're up about 30 percent year-over-year. Certainly don't wanted to go a whole lot higher. But for right now, we've been able to pass on in not seeing degradation in units. The other area is in things like laundry, where you had a very specific tariff. The entire industry has accepted that cost increase based on the tariff and you're seeing retails in all competitors that have gone up, more or less mirroring the impact from the tariff.

Operator

Our next question comes from Steve Forbes with Guggenheim Securities.

Steve Forbes - ***Guggenheim Securities - Analyst***

You mentioned piloting the first new supply chain facility this summer. But can you help us or help expand on that? What type of facility is it? And maybe just give us your updated plan for this year as far as how many and what type of facilities you plan on opening in 2018?

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

It's Mark Holifield here. The facilities we're going to be doing first are our market delivery operations, which are the hubs out there. These are stockless locations that will be delivery hubs for big and bulky product like appliances and vanities and things like that. Later this year, we'll be testing our flatbed distribution capability and opening our first local direct fulfillment center.

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

And Steve, I'd like you to remember that this is a 5-year plan. We've committed $1.2 billion in our supply chain over the next 5 years. We will spend as much in year four as five as we do in year one through three. So it's definitely going to ramp up over time.

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

Yes, I mean, perhaps, a way to think about it is if you live think back to our RDC rollout years ago. In the first year 2007, we had exactly one RDC. In 2008, we did four. 2009, we did seven. 2010, we did seven. So you'll see a ramp somewhat similar to that across the five years of the supply chain transformation ahead.

Steve Forbes - ***Guggenheim - Analyst***

And then just a quick follow-up. On retail services, so recognize the percentage of revenue here. But it's a topic I find interesting as you think about the opportunity to build brand awareness and share of wallet, right, with the DIY consumer here. So can you touch on how that business performed during the quarter?

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

Yes, our services business, it represents about 4 percent of our total sales and grew low single-digit, really driven by HVAC and window treatment. Wasn't much exterior business happening.

Operator

We'll continue on to Keith Hughes with SunTrust.

Keith Hughes - ***SunTrust Robinson Humphrey - Analyst***

Another product question, specifically on flooring. You did very well in flooring last several years, particularly carpet, just kind of a declining industry. But you've called out luxury vinyl plant. I assume you mean LVT there is growing well. Can you talk about your hard service offering, how that's growing and what you see for the future?

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

Yes. Overall, flooring again, we're very happy. Our comps and flooring were above the company average, for sure led by the LVT. That product is just a fantastic product, solid for waterproof vinyl product that looks like tile and/or wood. The rest of the business is solid. I mean, lot of sales moving into that LVT product. But the rest of the business is sort of low single-digit comp.

Operator

Our next question comes from Chris Horvers with JP Morgan.

Tori Bertschy - ***JP Morgan - Analyst***

This is Tori on for Chris. For some prior quarters, it would seem that Pro is comping 10 percent. Is that fair? And can talk about the performance of Pro in the first quarter and if you think that impacted the business?

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

Well, we certainly had a strong Pro quarter, and it outpaced in the DIY business in total, largely due to the fact that the garden business was obviously down dramatically in the DIY space. But we're very pleased with our Pro. And Bill, if you want to add to that?

Bill Lennie - ***The Home Depot, Inc. - EVP, Outside Sales and Services***

Well, Craig, just kind of a follow-up on engagement. Craig mentioned the tools that we're providing to our account managers in the stores are PASA’s. And as they get more engaged, we are seeing customers expand the number of categories that they purchase. We're seeing them start to utilize more services like delivery. And as a result, we're seeing accelerated growth in the accounts that are managed by our PASA’s. So great strength in Pro and top performing Pro trades, where our renovator remodeler are property investors and property managers. So we're pleased with the progress and the trajectory of the business.

Tori Bertschy - ***JP Morgan - Analyst***

And as my follow-up, following up on the May commentary, can you talk about what you've seen from the acceleration from Pro versus DIY quarter to date?

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

I mean, we're seeing both in May. The whole store is lifting.

Operator

Our next question comes from Seth Sigman with Credit Suisse.

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

A couple of follow-up questions here. So first, just on the delivery from the store. It's continue to grow at this double-digit rate pretty much since you guys have rolled it out. Can you help us understand how meaningful that is today in terms of the overall contribution? And also, the influence that it may be in driving higher transaction size. Because it does seem a big differentiator for you.

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

I mean, we're pleased overall with what's happening on the delivery side of the business. We don't break out those numbers specifically. But we are seeing very nice growth and as Mark said earlier, that is attracting both incremental business with current customers and new customers into the business.

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

Okay. And then when you look at the online growth this quarter, up 20 percent, obviously, very strong again. Is it fair to assume there was really little weather impact there. And you discussed a couple of things that may be helping. Any more insight into where the growth is coming from, the types of categories? And also, from a profitability perspective, just the progress you're making there in improving the margins in that business. Thank you.

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

So let me, I'll answer the second part of that and I'll turn it over to Kevin Hofmann. From a profitability standpoint, we run this on a portfolio basis, and it's an interconnected experience. So in many, many cases, the experience starts in the digital world, it may finish in the physical world. Over 45 percent of our orders the customer chooses to pick up in one of our stores. So we manage the portfolio, if you will, on a profit basis across the channels.

Kevin Hofmann - ***The Home Depot, Inc. - CMO and President of Online***

Just from the health of the online business. So we were really pleased with the traffic growth we saw. Ted mentioned we had double-digit improvement in our conversion rates because of the experiential experience we've been putting in place. But just super excited some of our fastest-growing sales are in what we call those interconnected sales, where the customer is buying online, picking up in store; buying online, shipping to store, and that was some of our fastest growth. And really across the store, flooring did great, plumbing did great, electrical did great. We were very pleased.

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

So there actually is an impact from a seasonal standpoint in the online business. When it's snowing on the ground in April, people aren't really looking online for patio furniture, for example. So it's kind of funny, but there actually is an impact.

Operator

We'll continue on to Brian Nagel with Oppenheimer.

Brian Nagel - ***Oppenheimer - Analyst***

So my first question. Just on the ticket growth. Clearly, a lot of discussion around weather. If you look at the ticket growth, it tracked higher in the quarter and I think went highest rates in a while. What's behind that? And how should we view the sustainability of that metric? And I have a follow-up.

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

I'm assuming you're referring to the $900 and above.

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

Or the average ticket of 5.8?

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

Or the average ticket of 5.8?

Brian Nagel - ***Oppenheimer - Analyst***

Yes, I was talking more about the number in the press release, the average ticket of 5.8.

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

So if you look at the average ticket of 5.8, think about the commodity impact plus the FX impact, and that gets you back to kind of where we've been running all of 2017 quarter-by-quarter.

Brian Nagel - ***Oppenheimer - Analyst***

Okay. So it's -- there hasn't much changes besides...

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

No, not at all.

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

No.

Brian Nagel - *Oppenheimer - Analyst*

Then the second question I have, I guess, from a bigger picture perspective. We talked a lot about just you mentioned the ongoing strength of the macro environment. Clearly, looking at my screen right now, we do have rates rising, albeit on lower -- historically low levels. The question I have is, what do you watch? I mean, why you guys were very good job watching a lot of factors out there. What are you watching for maybe some potential, early indications of an impact of higher rates upon your business?

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

Yes. So there are a number of things that we look at, obviously. During the recovery, we were always looking for green shoots and our looking for red flags, luckily we are not seeing any of those. But here's what we're looking at. As you see, rates are going up. 30 year mortgage, I don't know what your screen is showing. The last time I looked, it was about 4.6 percent, and it's on its way up, projected to be up at least 5 percent by 2020. Historical mortgages over the past, gosh, 50 some odd years, it's 5.8 percent. So we're considerably under those historical mortgage rates. But we are super focused on the Affordability Index and what that means in terms of performance by market. So if you look at the Affordability Index for the country at large, it's 152 percent, which is still very good. The average, over again decades, is about 127 percent.

So if the Affordability Index were to reach 127 percent or under, that would certainly be a red flag. And then we look at rising home prices coupled with rising mortgage rates. You see in markets where you might argue there's an overheated housing market or at least certainly one that's on fire, is there anything happening to our business? So I would call out 2 markets, Denver, Colorado and Seattle, Washington. Both have had seen extraordinary expansion of home price appreciation. The business there is very good, and the reason is because the economy is very good. So you can't just look at housing prices and interest rates and say, "Oh, oh", you got to then look at what's happening to the economy.

So it's getting a bit more complicated than it has in the past because there are all these influences of business. But certainly, if I stop talking just tell you what we look at every day, we look at ticket and transactions, ticket and transactions. Because if you go back to the last recession, ignoring the housing downturn recession, but the last recession in the United States had 2001, our ticket was flat. So we're looking at that. And then, of course, transaction. Because transactions can be an indicator of a few things, right? It could be an indicator of slowdown in demand or an indicator that competitors taking your customer way. So hopefully, that's helpful, Brian.

Operator

Our next question comes from Elizabeth Suzuki with Bank of America Merrill Lynch.

Elizabeth Suzuki - *Bank of America Merrill Lynch - Analyst*

I think you had expected before to experience a similar net sales impact from Harvey and Irma in 2018 as in 2017. Is that still the expectation? And will the benefit be limited to the first half? Or could there be some residual benefit in the second half as well?

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

Our expectation is that the sales will be the same year-on-year. The majority of the benefit will occur in the first half. There may be some trail-on benefit in the back half because the issues in Puerto Rico are so dramatic, but it won't be material to the company.

Elizabeth Suzuki - ***Bank of America Merrill Lynch - Analyst***

Okay. And then shifting over to online. I mean, what are the product categories that are doing well online, and which are more traditionally sold in-store and don't do very well online? And then how frequently are you able to adjust your online pricing to stay competitive?

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

So first of all, what I'd say is largely, our business online is incremental sales. We're growing the categories in store at the same time that we're growing online. And I'll let Kevin speak to the categories.

Kevin Hofmann - ***The Home Depot, Inc. - CMO and President of Online***

Yes, as I mentioned, so still strength in our core tools department, our plumbing department, our electrical department. Really, the core of the store has been performing very nicely. We've got a great bath business online as well. In your question around pricing, it's just like how we think about it in the store of being priced competitively every day and making sure that we differentiate, not just on price, but on the full service offering to the customer, the experience and all the things that we bring to the table. So very actively monitoring and managing the price situation online just like we do in the store.

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

We can move prices obviously online instantaneously. We purposely, because of how it impacts the store environment, don’t move the prices in the store at a different rate than we do online.

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

And I don't want to forget that the interconnected aspect of our online business as well because things like the lumber department pages or building material pages are some of our most active pages because the Pros are looking at price and the inventory available. So while they're not transacting as much online in those departments, we have great traffic on those pages.

Operator

We'll continue on to Seth Basham with Wedbush Securities.

Seth Basham - ***Wedbush Securities - Analyst***

Could you guys give us some color on the comp or the growth in comp transactions by ticket size?

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

Yes, we talked about big ticket already. So I suspect you are wanting to know what happened with the smaller ticket?

Seth Basham - ***Wedbush Securities - Analyst***

Correct.

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

Yes. So as you would anticipate, for transactions with tickets of $50 or less, they were down year-on-year. That was because of our garden business. And I can make this really real for you. If you can think about penetration of tender and you may say why, we can look at penetration of tender in the quarter. Our private label credit card penetration increased by 50 basis points. At the same time, our cash tender decreased by 50 basis points. And that was all related to our garden business, which is a smaller ticket activity.

Seth Basham - ***Wedbush Securities - Analyst***

Fair enough. If you think about the transaction growth overall ex-garden, how positive was it? And how does that compare to recent quarterly trends?

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

It was a positive 1.1 percent for the quarter and continues to be positive. As we said, May comps for the company are double-digit comps.

Operator

We'll now hear from Dennis McGill with Zelman & Associates.

Dennis McGill - ***Zelman & Associates - Analyst***

First question just had to do with the pilot program on the delivery from car and van. Can you maybe elaborate a little bit there what you're seeing from that uptake and particularly at the category or customer level? Are you seeing Pro versus DIY being more heavy with that uptake?

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

It's still early days, and customers are choosing to purchase all sorts of things. It could be a Pro on a jobsite needing something. But there's a lot also on the Buy Online, Deliver From Store front. So it's interesting to see where it goes. It's not taking a real pattern at this point.

Dennis McGill - ***Zelman & Associates - Analyst***

Okay, great. And then, Carol, can you elaborate. On the transportation costs increase that you experienced in the quarter, the deleverage there. Is that fuel alone? Or you seeing any issue with availability? And where do you see that trending for the year within guidance?

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

No, it wasn't fuel alone. We had 8 basis points of gross margin contraction in transportation, of which 3 basis points was fuel and 5 basis points was the pressure in transportation. We're not alone. All companies are facing higher transportation cost. And as you know, as our practice, we will figure out a way to work through this, but we certainly got some challenges ahead.

Operator

Our next question will come from Dan Binder with Jefferies.

Dan Binder - ***Jefferies - Analyst***

It's Dan Binder. Carol, you mentioned a margin mix impact on gross margin. Was that primarily from the seasonal mix? And how should we think about that for Q2? And then my second question was around credit. And just curious if you can get your thoughts on demand for credit, use of the credit lines that are out there, average spending on credit and delinquencies?

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

Yes. So on the margin expansion that came from mix and acquisitions, that was 14 basis points in total, of which 6 basis points was mix and 8 basis points came from our recent acquisitions. Those acquisitions being The Company Store and Compact Power. As we look to the second quarter, obviously with an increasing penetration of the garden business, which is a lower margin category, that's an impact on gross margin. But we're going to have benefit in other areas, too. So nothing comes to our attention that says we can't deliver the gross margin guidance that we just provided and updated with you today.

On our private label credit card, really pleased with the performance. As I mentioned, we saw 50 basis point improvement in penetration year-on-year. What we're seeing is a very healthy portfolio. The average net receivable, which obviously isn't -- underwritten by us, it's underwritten by a third-party, but it's over $12 billion. We had 1 million new accounts opened year-on-year and we're seeing pretty good utilization on those accounts. For the consumer, the utilization is around 29 percent. For the Pro, the utilization is around 23 percent. And our approval rates are north of 70 percent for both the consumer and the Pro.

Part of the change in accounting for us is moving all of the aspects of our private label credit card up to the revenue line. And included in the benefit that we removed out of our selling expenses and move up to the revenue line was gain share. Gain share is our profit-sharing program with Citi who underwrites this card for us. The way the portfolio has gains is there's an EBIT threshold that must earn and anything over that a bit threshold, we share in it. And that percentage of sharing changes over time. Embedded in that EBIT threshold, of course, is that you've got to make sure that the portfolio doesn't have high losses because that could impact your gain share. And our losses, this is a long-winded answer to your question, but our losses are running at/or below historical average. So the portfolio is very healthy.

Operator

Our next question comes from Chuck Grom with Gordon Haskett.

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

Just on the gross margin line. Just a follow-up on the transportation cost. Just wondering if you could characterize how they came in relative to your original expectations. And then I have a follow-up.

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

We didn't anticipate deleveraging the supply chain in the first quarter to the extent that we did. The team did an awesome job, though, of managing spiky demand, pressure coming from all kinds of new areas. So manage through it.

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

Okay. So you would expect that headwind to continue over the balance of the year?

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

No, there’s definitely pressure coming at us for the balance of the year. But we'll manage through it.

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

Okay. And then just on the weather here. Obviously, you guys have a lot of experience dealing with it. When you think about it, does the business could simply delay here and you recover most of it? Or do you lose some of it because the window just simply closes?

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

No, we'll actually recover most of the business. There may be a piece here and there that you missed, like part of the preemergence. But even in that, we feel like we're getting most of that business right now, particularly in the north. So the majority of this business will be recovered.

Operator

We'll continue on to Matt McClintock with Barclays.

Matt McClintock - ***Barclays - Analyst***

McClintock. Carol, I was wondering if we could take the housing question for more of a generational perspective. It seems like a lot of the long-term optimism for the housing market to stay strong is driven by the millennial generation forming households. But can you talk about maybe trend changes that you're seeing in the other generations? And I only asked because it seems like a lot of the story of baby boomers may be moving, downsizing their household seems to be kind of minimizing?

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

Yes. Well, as we look at mobility rates, we see mobility rates declining by all age cohorts particularly baby boomers like me. There's been some great research that came out of the Harvard Joint Center for Housing Studies that suggest the desire is to age out in your home. Think about what that means for home improvement. There's nothing but opportunity. So that's just one trend.

Matt McClintock - ***Barclays - Analyst***

Can you maybe dig into some of how the opportunities do change for you and how you position yourself for some of those changes just a little bit more?

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

Well, yes, I mean, if you think about flooring, for example. That's something that people look at as they age in their home, how do you make sure you eliminate trip hazards. You think about bath remodels and the ability to put in walk-in showers, for example, so that you don't have to step into a bathtub where you have the potential to slip. You think about lighting around the home becomes an important factor, both inside and outside of the home. You think about security. So there's lots of factors that go into how somebody thinks about changing their home if they're aging out in their home.

Operator

Our next question comes from Peter Benedict with Baird.

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

I appreciate the Stamford, Connecticut store. The..

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

Sure. It did $1 million the first week, it's an awesome store.

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

There you go. Well done. Given the traction online with categories like tools, electrical, bath, just can you remind us how you're rethinking the space allocation within the stores to take advantage of the opportunities across different categories? That's my first question.

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

Sure. I think, as I mentioned earlier, our online business for all practical purposes is incremental. So we actually haven't seen the need to make a lot of shifts in space. It's something that we look at on a continual basis, but we really haven't had to do that at all.

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

No, I'd say, Craig, the space that we're doing speaks more than the interconnected nature of our online business, where we're putting lockers in the front of our stores. We'll do about 1,000 lockers this year. And we're also adding some bigger holding area for bulkier items near the front of the store. So space allocation is more for online pickup than any merchandising changes in the bay.

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

46 percent of our online orders are picked up in the store in the first quarter.

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

Okay, that is terrific. It makes sense. And then Carol, back to kind of the red flags that you're keeping an eye on out there. How about -- what are you watching when you think about the leverage guard rail for the business. Interest rates are going up here. But I mean, is there a level or a point at which the 2.0 becomes something that you're not comfortable with? Or how should we think about that?

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

Well, I'm really pleased with how we've managed our capital structure over the past several years. If you look at our -- the amount of debt that we have outstanding, long-term debt, excluding current maturities, $24 billion, the average maturity of that debt is 13.6 years. The coupon is 3.7 percent. The latter maturity go out 40 years. So we really worked hard to not put any financial risk into the company. And with an adjusted debt to EBITDAR target of 2x. That implies we can get the debt payoff in a very short period of time. So comfortable with that leverage, always going to be mindful of not putting the company into financial distress, but we're comfortable with where we are today.

Operator

Our next question comes from John Baugh with Stifel.

John Baugh - ***Stifel, Nicolas & Company - Analyst***

Just quickly, since you are hyper-focused on the transactions, and thanks for the 1.1 number in April ex garden. I know you don't guide to that figure. But it sounds like May is well up. You've been running at 2 percent plus, I believe, fairly consistently. Is there any thought around that number for the year in light of the start to the first quarter?

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

So the 1.1 was for the quarter ex our garden business. It wasn't for April. So that was for the total quarter. And we think about the balance between ticket and transactions are being relatively even over time, and that's how we plan the year.

Operator

Matt Fassler with Goldman Sachs has our next question.

Matt Fassler - ***Goldman Sachs - Analyst***

My first question is for Carol. You spelled out a 56 basis point impact on the expense ratio from your investment plan. Can you spell out here at the outset of that program where some of that money went and whether that's the kind of impact you would expect to see through the year or whether there's a better top line, if that impact should dissipate a bit?

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

Sure. So I talked about expense deleverage and levers as a percent of sales. I didn't really talk about the expense growth factor. But let's use that nomenclature because that's how we've guided for the year. So the expense growth factor in the first quarter was 202 percent and the drivers of that were Rev. Rec., which was 57 percent; investments in the business, 70 percent; and then what we call BAU, business as usual, 75 percent. And in that business as usual, there's about 12 percent of acquisition-related expenses, companies that we've acquired.

So we focus -- then on the guidance we gave for the year, clearly, it's going to get better. And it's going to get better for a couple of reasons. First, we have $167 million of hurricane-related expenses in the back half that will not repeat. So you should model higher expense growth factor in the first half than in the back half. Secondly, and you've heard Ann-Marie talk about this, we have a new labor model, which more effectively allocates our hours to our activity. That starts to kick in into June. So we should be driving more labor productivity than we saw in the first quarter.

Then if I focus simply on the investments in the first quarter, the dollar amount of investments, and I'm not going to call this out every quarter, but because they get into this, I'll give you this color. The dollar amount of the investments were $144 million in the quarter. And those dollars were used for increased wages for our people, for increased advertising as we move to a more marketing technology platform; increases in display costs. You heard Craig call out what we're doing inside of the stores. And then increase in headcount. We've got to have some people on board to help us do all of these investing. In fact, I believe we've hired 350 people alone in our IT organization. So these are investments that we're making to reach those sales and operating margin targets that we laid out for 2020.

Matt Fassler - *Goldman Sachs - Analyst*

That is great detail. If I could follow up on a couple of disclosures you made on the monthly trends. Was there any weather impact on the first 2 months of the quarter on February and March? And then, when you think about the bathtub effect, if April was really the only month that was impacted. You tend to recapture most of those lost sales in the month of May? Or does the bathtub effect push out until June and July?

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

Yes, so there definitely was impact still in the other months as well. And the recovery of that, you'll get a significant piece in May, but it will actually flow into June and July as well.

Operator

Our next question comes from Scot Ciccarelli with RBC.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

So are you seeing a greater appetite for jobsite delivery from your Pro customers?

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

Certainly.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

Okay. So obviously, that is the case. Now over time, do you think that happens to change your historical real estate advantage that you've had against some of your major competitors or maybe even open the door to higher levels of e-commerce competition because then the physical location or physical structure of The Home Depot store maybe gets partly marginalized over time?

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

Actually, when you think about our location and footprint, we'll actually leverage that as an advantage overall to our business, where we are well-positioned across markets, including urban markets and sit within 10 miles of 90 percent of the U.S. population. So no, we actually see this as an advantage. And Mark?

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

Yes, I mean, you will recall from the investor conference, we outlined 40 flatbed distribution centers, and we expect to open those to take some pressure off of the stores. But our stores are going to be in the delivery business in smaller markets for a good long time. They're still ideally located and a great place to originate of those deliveries from. In urban markets, those flatbed distribution centers will take a lot of pressure off of those high volume store.

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

I think the other thing you have to think about is actually, not just the downstream portion of our supply chain network, but the advantage that we actually have as a result of the upstream portion of our supply chain moving goods from our suppliers to our stores and our distribution centers. It's those things working in combination that will create in the fastest most efficient delivery in home-improvement.

Operator

And our final question this morning is from Alvaro Lacayo with Gabelli & Company.

Alvaro Lacayo - *Gabelli & Company - Analyst*

It's Alvaro Lacayo here. Just one question on update on the capital allocation. Carol, last call, you said you were going to provide us with an update later on given that cash flow from operation was going to be a little bit higher than where sort of guided dividends and share repurchases and just some commentary around if there's any updated thoughts there.

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

Yes. So we've been working on how to best use the cash this coming off the business through lower taxes. We aren't announcing anything today. We have a Board meeting this week. So we will keep you apprised, expect a more thorough update at the end of the second quarter. But with that, let me just say that our principles are in changing. The first use of cash is to go back and support of the business and our strategic imperatives. The second is to pay our dividend. Anything that's left over goes to share repurchases.

Operator

And I'll turn the floor back over to our speakers for any additional or closing remarks.

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

Thank you for joining us today. We look forward to speaking with you on the second quarter earnings call in August.