

HD – Q2'19 Home Depot Earnings Call

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PRESENTATION

Operator

Greetings and welcome to the Home Depot Second Quarter 2019 Earnings Call.

(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

Thank you and good morning, everyone.

Joining us on our call today are Craig Menear, Chairman, CEO and President; Ted Decker, Executive Vice President of Merchandising; and Carol Tomé, Chief Financial Officer and Executive Vice President, Corporate Services.

Following our prepared remarks, the call will be opened for questions. Questions will be limited to analysts and investors. (Operator Instructions) 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 Craig, let me remind you that today's press release and the presentations made by our executives include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These statements are subject to risks and uncertainties that could cause actual results to differ materially from our expectations and projections. These risks and uncertainties include, but are not limited to, the factors identified in the release and in our filings with the Securities and Exchange Commission. Today's presentations will also include certain non-GAAP measures. Reconciliation of these measures is provided on our website.

Now let me turn the call over to Craig.

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

Thank you, Isabel, and good morning everyone.

Sales for the second quarter were \$30.8 billion, up 1.2 percent from last year. Comp sales were up 3 percent from last year, with U.S. comps of positive 3.1 percent. Diluted earnings per share were \$3.17 in the second quarter.

We were pleased with these results. We overcame a tough May and continued lumber price deflation to deliver accelerating comp performance throughout the quarter.

Looking at our results geographically, all of our U.S. divisions posted positive comps. Seventeen of nineteen U.S. regions also posted positive comps, with the exceptions being our Gulf and Florida regions, which delivered high storm-related comps last year.

Internationally, Mexico posted high single-digit positive comp and Canada posted low single-digit positive comp, both in local currency.

We saw broad-based growth across the store as both comp ticket and transactions grew. With the exception of lumber, all of our merchandising departments posted positive comps. We saw a healthy balance of growth among both Pro and DIY categories, with Pro sales outpacing our DIY business in the U.S.

As Ted will detail, we continue to invest in a portfolio of service offerings to deepen our level of engagement with the Pro. We know that the more dimensional our relationship is with this customer, the more they spend.

From a strategic perspective, I am encouraged by the progress we are making to deliver the One Home Depot experience - a seamless, interconnected shopping experience for our customers.

Our in-store investments are focused on ease of navigation and improving speed to checkout. We have implemented our wayfinding sign and store refresh package in over 1,400 of our U.S. stores and customer service scores in the category of “neat and clean” have increased 140 basis points. Our front-end store investments, now in over 400 stores, are designed to get customers in and out of stores faster and they are doing just that. Customer service scores in checkout time satisfaction have increased over 450 basis points versus last year.

While our stores remain the hub of our business, we know that many of our in-store sales are influenced by online visits and approximately 50 percent of all online U.S. orders were picked up in our stores during the quarter. Our customers continue to blend the channels of engagement and we are investing to remove the friction as they do. We continue to roll out automated pick up lockers for online orders, with over 1,100 stores completed, and have seen a 250 basis point increase in checkout scores for stores with lockers versus those without. Our investment in the digital price labels for our appliance department has enabled us to incorporate ratings and reviews from the digital world into the store shopping experience, enhancing the overall customer experience in the category.

As we invest to address the unique demands of an interconnected customer experience in stores, we also continue to invest in our website and mobile applications to further enhance the digital customer experience. Our focus in improving search capabilities, site functionality, category presentation and product content has yielded higher traffic, better conversion and continued sales growth. Second quarter online sales grew 20 percent from the second quarter of 2018. We also continue to leverage our digital platforms to drive incremental growth from new categories as we lean into adjacencies like HD Home, pool and workwear.

The traction we are seeing from investments across our digital and physical assets are encouraging not only from a customer experience standpoint, but they are also driving productivity throughout the business. Our front-end investments are optimizing labor and merchandising space productivity. Digital appliance labels enable associates to be more productive with their time. Instead of spending multiple hours manually changing price signs, our associates can re-allocate their time to engage with customers in a high-touch category. The virtuous cycle of productivity at the Home Depot has been a hallmark of our operational excellence over the years and continues as we move forward.

Our focus on enhancing the customer experience and end-to-end productivity extends to the supply chain investments as well. During the quarter we completed the retrofit of our Hagerstown facility into a parcel direct fulfillment center, which expands our one-day delivery capabilities for stocked-parcel goods from approximately thirty percent to approximately fifty percent of the U.S. population. We also drove productivity and cost out through our mechanization efforts in our upstream supply chain. We are on track with our plans to create the fastest, most efficient delivery network in home improvement and are pleased with the progress we have made thus far.

Turning to our outlook for the remainder of the year, the building blocks of our financial model remain in place. As Carol will detail, we are lowering our sales guidance for the year mostly to reflect the impact of lumber price deflation, as well as some conservatism to account for the recently announced tariffs. We now expect fiscal 2019 comp sales growth of approximately 4 percent and reaffirm our expectation for diluted earnings per share of \$10.03.

I want to close by thanking all of our associates for their hard work which resulted in the highest quarterly sales in our company's history.

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

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

Thanks Craig and good morning everyone.

While we had a slow start to the second quarter, we were pleased to see demand accelerate throughout the quarter, as we helped our customers tackle a variety of interior and exterior projects.

Looking at our departments, comps in appliances, tools, décor & storage, indoor garden, building materials, paint, outdoor garden, hardware, and plumbing were above the company average. All other departments with the exception of lumber were positive but below the company average. Lumber reported a high single-digit negative comp due to commodity price deflation.

In the second quarter, comp average ticket increased 2.0 percent, and comp transactions increased 1.0 percent. Lumber prices remained depressed during the second quarter and as a result, lumber negatively impacted our average ticket growth by approximately 110 basis points. Last quarter we talked about a 4x8 sheet of OSB selling for about \$8, more than 50 percent below the price a year ago. During the second quarter, the price for that same sheet of OSB fell further to an average of about \$7.60.

During the second quarter, big-ticket comp transactions, or those over \$1,000, which represent approximately 20 percent of U.S. sales, were up 3.7 percent, reflecting in part, the impact of hurricane-related sales last year and lumber price deflation. Excluding hurricane-related markets only, big-ticket transaction comps were nearly 5.0 percent. During the quarter, we saw strong performance in big-ticket categories like appliances, vinyl-plank flooring, and patio.

Last quarter, we talked to you about opportunities in our flooring business. While vinyl plank has been, and continues to be, one of the strongest performing product categories across the store, we identified a need to refine our assortment within our other flooring categories. For example, in special-order carpet, we've recently taken several actions. We upgraded all of our showrooms, and reset the category to reflect the latest styles and trends, while offering a simpler shopping experience showcasing a good, better, best line structure. Given that associate engagement is extremely important for this category, we also enhanced our in-store training efforts to drive a better customer shopping experience. While early days, we're pleased with the results.

During the second quarter, we saw growth with both our Pro and our DIY customers, with Pro sales outpacing DIY sales in the U.S. We continue to focus on our suite of Pro initiatives, because we know that the more we engage with them, the more they spend with us. We've equipped our store associates with a number of tools aimed at better understanding their top Pro customers. Our MyView system allows our Pro sales associates to access customer data and information, so they can proactively work with our Pro customers and determine how we can better serve them. We continue to simplify the Pro shopping experience and expand engagement through services like tool rental, delivery, and our new B2B online experience.

While May was another wet month, we saw project demand in outdoor categories rebound, as weather improved. Categories like concrete, exterior paint and stains, live goods, and mulch had comps above the company average. In addition, we continue to see customers respond to our industry-leading brands and the innovation they are bringing to market. In our outdoor power equipment business, we are seeing strong customer demand and continued trade-up to cordless tools like blowers, trimmers, and even lawn mowers. Exclusive cordless product from brands like Ryobi, Milwaukee, DeWalt, and Ego provide our customers with superior functionality and run time to keep their yards looking great.

Switching gears, as you heard from Craig, we are happy with the progress we are making with our investments to deliver a best in class, interconnected shopping experience. Looking at our likelihood to shop again metric, 87 percent of our customers give us a best in class score of five. Our strategic investments include accelerated merchandising resets, focused on upgrading showrooms, improving visual merchandising, and refining assortments to drive a better in-store shopping experience.

For example, we are rolling out a new color solution center in our paint department, which simplifies the color selection process for our customers, while emphasizing our price, color, and satisfaction guarantee. And our new Project Color app and updated online experience, allows our customers to seamlessly explore, be inspired, and shop color online whenever or wherever they want. Another example is in pipe and fittings. We are resetting all of our bays, reconfiguring them to better showcase the assortment, and freeing up space to add new product categories for our customers.

Now, let's turn our attention to the back half of the year.

As the #1 retailer of ladders, we are pleased to announce an expansion of our partnership with Werner, the #1 brand for Pros. Multi-position ladders are the fastest growing segment in the ladder category, and we are now the exclusive big-box retailer of Werner multi-position ladders. We are also happy to announce an exciting new partnership with Louisville Ladder, as their exclusive big-box retailer starting in the fourth quarter. Combining Werner with our exclusive Louisville Ladder and Gorilla brands, we are the leading destination for top Pro brands in the ladder category.

Our merchants have worked hard to put together events and special buys for our customers in the third quarter. We are excited about our customers' continued appetite for home improvement projects and in just weeks, we will host our annual Labor Day event followed by our Halloween & Harvest event.

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.

As you will recall, fiscal 2018 had a 53rd week, which shifted our fiscal 2019 calendar. Our comp sales are reported on a like for like basis, but total sales growth is reported on a fiscal year basis.

In the second quarter, total sales were \$30.8 billion, a 1.2 percent increase from last year, reflecting the shift in our fiscal calendar as well as the impact of deferred sales.

Our total company comps were positive 3.0 percent for the quarter, with positive comps of 0.2 percent in May, 4.1 percent in June, and 4.6 percent in July. Comps in the U.S. were positive 3.1 percent for the quarter, with positive comps of 0.6 percent in May, 4.1 percent in June, and 4.7 percent in July. Versus last year, a stronger U.S. dollar negatively impacted comp sales growth by approximately \$29 million or 0.1 percent.

As you just heard from Ted, during the second quarter, lumber prices remained depressed. Versus last year, this lumber price deflation negatively impacted our comp sales growth by approximately \$340 million, or over 100 basis points.

In the second quarter, our gross margin was 33.8 percent, a decrease of 19 basis points from last year. The year over year change in our gross margin reflects the following factors:

- First, higher shrink than last year resulted in approximately 9 basis points of gross margin contraction;
- Second, changes in the mix of products sold drove approximately 8 basis points of gross margin contraction.
- And finally, we had 2 basis points of gross margin contraction in our supply chain, driven primarily by start-up costs associated with our One Home Depot supply chain initiative;

In the second quarter, operating expense as a percent of sales at 18.0 percent was essentially flat compared to last year. Our operating expense performance reflects the impact of our strategic investment plan and good expense control during the quarter. Specifically:

- Expenses related to our strategic investment plan of \$242 million, increased by approximately \$28 million from last year, and resulted in approximately 8 basis points of operating expense deleverage;
- This deleverage was offset by productivity in BAU, or business as usual expenses, which drove 7 basis points of operating expense leverage.

Our operating margin for the second quarter was 15.9 percent, a decrease of 21 basis points from last year.

Interest and other expense for the second quarter grew by \$37 million to \$283 million, due primarily to higher long-term debt levels than one year ago.

In the second quarter, our effective tax rate was 24.6 percent compared to 24.7 percent in the second quarter of fiscal 2018. For the year, we now expect our effective tax rate to be approximately 25 percent.

Our diluted earnings per share for the second quarter were \$3.17, an increase of 3.9 percent from last year.

Now moving on to some additional highlights...

During the quarter, we opened two new stores, one in the U.S. and one in Mexico, for an ending store count of 2,291. Selling square footage at the end of the quarter was 238 million square feet.

Total sales per square foot for the second quarter were \$510, up 1.1 percent from last year.

At the end of the quarter, inventory turns were 5.1 times, down from 5.4 times last year; reflecting, in part, a load-in of inventory in support of our strategic initiatives. For the year, we now expect our inventory turns to slow slightly from what we reported in fiscal 2018.

Moving on to capital allocation...in the second quarter, we repurchased \$1.25 billion, or approximately 6.2 million shares, of outstanding stock. We plan to repurchase approximately \$2.5 billion of outstanding shares in the second half of the year, bringing fiscal 2019 share repurchases to \$5 billion, in-line with our guidance. Further, during the quarter we took advantage of an attractive interest rate environment and raised \$1.4 billion of long-term debt, of which \$1 billion was used to repay senior notes that came due in June.

Computed on the average of beginning and ending long-term debt and equity for the trailing twelve months, return on invested capital was approximately 43.7 percent, 580 basis points higher than the second quarter of fiscal 2018.

Now turning to our outlook for the remainder of the year...

While global economic pessimism has increased due to geopolitics, currently the U.S. consumer remains healthy. Consumer confidence is near record high levels and wages are up over 3 percent from last year. Housing metrics are in line with the assumptions we used to build our 2019 financial plan. Nonetheless, what we didn't expect when we built our plan was the significant lumber price deflation we've experienced... we are now more than halfway through the year and lumber prices are below the levels we saw in the first quarter of fiscal 2019. Additionally, the U.S. consumer is facing the impact of tariffs. While trade discussions are fluid, consumer demand could be impacted. Today we are updating our fiscal 2019 sales and earnings-per-share growth guidance to reflect these changes.

Remember that we guide off GAAP, so fiscal 2019 guidance will launch from our reported results for fiscal 2018, which includes sales and earnings associated with the 53rd week. For fiscal 2019, we now expect comp sales, as calculated on a 52-week basis, to increase by approximately 4 percent, that's down 100 basis points from the 5 percent growth rate we planned at the beginning of the year reflecting for the most part, lower lumber prices, as well as some potential impact to the U.S. consumer from recently announced tariffs.

With this, we now expect sales to increase by approximately 2.3 percent, reflecting the compare to 53 weeks last year. We are also reaffirming our earnings-per-share growth guidance for fiscal 2019. For earnings per share, we expect fiscal 2019 diluted earnings per share to grow approximately 3.1% to \$10.03. We are able to hold our earnings per share guidance to what we initially planned as lumber is a lower margin category and because we are projecting a lower tax rate than our original plan.

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

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

Christine, before we open the call up for questions, I'd like to turn the call back over to Craig.

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

Thank you, Isabel.

As I mentioned on our last earnings call, Carol Tomé will be retiring as our CFO at the end of this month after 24 years with the company.

She has served as our chief financial officer for the past 18 years. And in fact, today's call is the 73rd consecutive quarter that she has reported our financial results to the market.

I'd like to thank Carol for her deep commitment to our associates, the investment community and our shareholders.

Carol has set the standard for excellence and transparency during these calls, reflecting not only her in-depth knowledge of our business, our operating environment, the economic environment but also her dedication to our values.

So Carol, let me say thank you for your leadership and for your partnership in your 24-year career at Home Depot. You will definitely be missed.

And Christine (inaudible) for questions.

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

Thank you, Craig. And we'll try to get through the questions without me crying.

QUESTION AND ANSWER

Operator

(Operator Instructions) Our first question comes from the line of Michael Lasser from UBS.

Michael Lasser - *UBS – Analyst*

Good morning thanks for taking my question, that's a hard lead in to ask a question off of Carol. Carol, congratulations and best of luck. And you too, Richard. Good luck in following those very large footsteps. So my first question is we have assumed that about 3 quarters of the reduction in your full year comp guidance is due to the lumber price changes and the remainder still about 1/4 of a comp point is due to the macro. There's obviously been a lot of concern in the macro recently, given the yield curve inverting a large education institution that's calling for a significant slowdown in remodeling activity. And then as you pointed out, the tariff concern, do you think a 1/4 of a point reduction in your comp guidance sufficiently considers all of those uncertainties?

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

Michael, let me make a couple of comments and I'll turn it over to Carol. So first of all, when you look at the overall macro factors that we think are critical to how we line up our business, those will largely remain unchanged. And so we feel good about the fact that the consumer has wages is up about 3% year-over-year, consumer confidence is still high. So the general trend that we see in the macro based on how we did our plans really hasn't changed much. And we feel pretty good about that.

And then when you think about going forward in the business, when we look at commodity hurricane May, and then compared that to where we were at the end of the quarter, we feel good about the guidance that we have.

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

I'll give you a little bit more color there, Michael. So the implied back half comps in the guidance that we just gave you is around 5%. So if you look at our reported comp in the second quarter in the U.S. it was a 3.1% comp. If you add back the impact of hurricane-related sales, that's 50 basis points deferred. If you add back the weather driven demand softness that we saw in May, that was 40 basis points deferred and you heard us talk about commodity being 100 basis points. So when you add that back, actually the normalized comp in the second quarter was 5%.

Then you heard Craig talk about the comp cadence and we excited July quite strong on an unadjusted basis, the comp in the U.S. was 4.7%. And then I look at our -- how we are performing relative to plan and we are on our plan. So you add up all of the data points, and it suggests that the comp guidance is very achievable. And the other way to look at it is just stack the comps. You stack the comps for the first half of this year against last year, it's back to second half, what we reported and what we're guiding to, that is the stack comp is about the same in and both of the halves. So every way we look at it, we feel very good about the guidance that we've given.

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

Michael, I guess the last comment that I have on it is if the consumer softened in any way, I'll bet on this team all day long to go after the business.

Michael Lasser - *UBS – Analyst*

No doubt. And Carol, you mentioned you're on your plan, do you mean you're on your plan where you stand quarter-to-date, such that you really haven't seen any impact from the tariffs flowing through to the consumer as of yet?

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

Yes, that's exactly what I mean. The beauty of our business is that we see sales on our phone. We can tell exactly how we're doing by the minute. So that's very different than that leading indicator of remodeling activity report that you just mentioned, which is based on a biannual survey of housing data coming out of HUD. We have real data at our fingertips. So we feel good about our performance.

Michael Lasser - *UBS – Analyst*

You might want to remove that app by the end of the month. And then my last question is on -- as you look at your guidance for the back half of the year, how should we model gross margin and SG&A, particularly between the third and the fourth quarter, recognizing that it's not so straightforward given that you will be lapping the extra week in the fourth quarter of last year?

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

Yes, so it's a little goofy isn't it, so I was -- talked through expenses and as we told you, we expect our expenses on a 52-week to 52-week basis, excluding the write-down that we took for some trade names that we're no longer using. We told you that our expense growth factor will be 90% for the year. For the first half, it was around 73%. It will be a little bit higher in the back half. And quarter-over-quarter, expect Q4 to be higher than Q3.

On the gross margin side, as we've indicated, our gross margin won't be as low as we had anticipated at the beginning of the year because of the penetration shift in lumber. So we will be slightly higher than our original guide. Our original guide was to be flat, that was a 34% for the year as you'll recall. So it won't be down as much. So the second half margin won't be down as much as the first half how about that.

Michael Lasser - *UBS – Analyst*

That's helpful. Thanks again and best of luck.

Operator

Our next question comes from the line of Simeon Gutman with Morgan Stanley.

Simeon Gutman - *Morgan Stanley – Analyst*

Well done, Carol. Congratulations. My first question is on the second half, I know you don't provide quarterly guidance, but can you share some cadence around the second half comp guidance and its dependencies? And I'm thinking about macro dependencies and strategic initiatives, and if you can share with us part of it on the strategic initiatives, which ones are expected to contribute to the most to the second half comps?

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

A couple of things to think about, if you think about the second half comps. First as you know, we're lapping \$800 million of hurricane-related sales, of which \$500 million occurred in the first half during \$300 million in the back half. So the hurricane sale overlap gets easier. Secondly, on lumber price deflation, let's just use a number of \$800 million to make it simple, about \$500 million of that occurred in the first half, so \$300 million will occur in the back half. So it is easier too. Then we have the impact of supply chain initiatives.

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

Yes, so on the initiatives, when you think about the Pro, first is the B2B website that we have launched. And we are seeing Pros that have been migrated onto the website react very positively from a sales standpoint. We are on track for the 1 million Pros in 2019, as a matter of fact, with the tail end of this quarter, we added a significant number of Pros to the website. As Ted detailed, My View capability that we've given to our associates in-store to better understand how we can engage with the Pro customer is delivering the results as well. And then we've made significant investments in our rental business, which we know is an important aspect of the Pro. 25% of the Pros rent from us today. We know that 90% of Pros rent tools. So we have an opportunity as we invest in this business to continue to grow.

And then in the digital investments, our HD Home program, as we expand categories to fulfill rooms in the home, as well as the investments we're making in search capabilities, category updates, are all leading to improved sales and conversion in the business. And then the number of investments that we've made in the store as well, whether that's our overhead management, which is driving productivity in the store, our interconnected lockers, which is enhancing the pickup experience for our customers or our merchandising resets are paying off in a nice way. I don't know if you want to give a little more color on the resets.

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

Yes, on the resets, we've been working on our appliance resets and our tool corrals for some time. Those 2 businesses continue to post incredibly strong results and we don't see that changing in the back half. More recently, we've been working through our pipe file reset, which is going extremely well we'll do about half the chain this year and that adds holding power in the room for some new assortment programs. And then soft flooring, I mentioned in our prepared remarks, for a while there you thought hey is soft flooring losing all ground to hard surface flooring what we've been seen in solid floor vinyl and tile. But resetting all of our soft carpet showrooms, those are done, we simplified our brand structure, we simplified our line structure and pricing structures. That has continued to accelerate through the quarter and exited the quarter at much higher than the company comps. So we're happy with what we've seen in soft flooring. And then lastly, our largest reset to come, which we've just launched the last several weeks and we'll finished the entire chain by the end of this year is our new Color Solutions Center in our paint department, where we'll be highlighting our Behr and PPG products and really pleased with that, the timing couldn't be better with the number of recent consumer surveys and consumer testing agencies, released the new winners for this year and Behr captured the top 3 paint products in the entire industry at the best value, and PPG posted the 2 top stain products at the best value. So we're very excited about all those resets.

Ann-Marie Campbbell - *The Home Depot, Inc. - EVP, U.S. Stores*

And Craig, just to add a couple of points from just driving the customer experience as well. Number one, you mentioned rental. We're continuing to see growth accelerate from half to half. So the investments we're making there are really driving exponential value and so we're going to continue to lead in there. To the point about driving event in the second half when we think about our comp cadence, Craig talked about over head management and our ability to find the product and get on shelf availability to a very, very high level is driving incremental performance. And for us, as we think about the investments, not only getting the product on the shelf it's how we get the customers to the store.

So we have done 450 front end transformations, we have heard the numbers that we've seen just the customer experience grow across the board. We're going to have over 800 by the end of the year. And we are able to deliver this performance by not only transforming our business but making sure that we're focused, simple and direct and drive into where the customer expects us to be. So we will continue to drive through that in the second half of the year and leverage the events to drive exponential differentiated performance.

Simeon Gutman - *Morgan Stanley – Analyst*

That was very comprehensive. I am going to ask my follow up. A year ago, when rates were rising we went through this hypothetical scenario, if we saw a recession I think we talked about scenario in which Home Depot would comp flat and margins could go to 12 if you made all the investments as part of your plan. I think we're now 1 year forward, you're making progress on margins, can you provide us another update would your margin end up better than that 12, given that you're closer now to some of your goals?

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

Well we haven't updated that recession model. Productivity is a virtuous cycle at Home Depot. But for modeling purposes, I would use the same number that we've shared with you before. And just on the state of the economy and when a recession might happen, we certainly can't predict that. But we know a few things, we are in the longest economic recovery in our nation's history. And yet the amount of growth during this recovery is still under the average of every other recovery in history. So this is one reason why it's been an elongated cycle. Further, the share of housing as a percentage of GDP has dropped. It's about 19% of GDP. Back in 2006 it was 22% of GDP. So whenever that downturn comes, and it will it is a cyclical economy. But whenever that downturn comes, it's nothing like it's going to be like it was before. So we are very well positioned to manage through all of that.

Operator

Our next question comes from the line of Scot Ciccarelli with RBC.

Scot Ciccarelli - RBC - Analyst

I had another follow up on the investments that you're making despite the pretty comprehensive answer you already provided. Can you help us better understand the cadence of the comp growth improvement that you're expecting both in the back half of this year as it flows into next year specifically targeted to these investments?

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

Well we've said in earlier statements that we believe that we'll achieve about a 1% impact in the back half of the year from the investments that we're making. When you took GDP, the housing benefit and then added in the investment, that's how we got to our growth overall. And the only thing that's changed from that for all practical purposes is the inflation of lumber.

Scot Ciccarelli - RBC - Analyst

But just to clarify, I think it was 1 point for the year all of which was kind of loaded into the back half or did I misunderstand that?

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

You're right. It's loaded into the back half. And the way that we've modeled it based on events as well as the completion of resets that you've heard from Ted is that the fourth quarter comp will be higher than the first quarter.

Scot Ciccarelli - RBC - Analyst

Got it. And we should presume that because of the changes and the customer interaction, a lot of these improvements should flow into next year? Or is there a point where you start to anniversary that and it levels off?

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

It will definitely flow into next year. We'll get to that guidance later in the year.

Operator

Our next question comes from the line of Christopher Horvers with JP Morgan.

Chris Horvers - JP Morgan - Analyst

I certainly echo Craig's comments and wish you, Carol the very best fortune in the next stage of your life. In terms of my questions, just a follow up on the macro. On the housing front, rates have moved around a lot, moved down quite a bit. I'm about to reset perhaps, personally. But pricing has moderated and existing home sales are not picking up. So is that what you were expecting? And then what are you seeing

out there in terms of the -- in the market, say, some of the coastal markets where that's really driving the deceleration and pricing and pricing coming down versus other parts of the country. And then related to that on the consumer front, are you seeing anything different in the consumer around near the type of projects that are they are taking on or perhaps the trade up versus the value orientation?

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

On the macro model yes, things are moving around a little bit. But that's just on the margin. So there is no material change to the inputs that create the output and drive our sales plan.

To your question about the coastal market, I'll just give you some data. Let's take San Francisco, it's on the coast, the comp was higher than the company average. Let's take San Diego, a little bit further south, the comp was at the company average. Let's take New Jersey, which is a high SALT state, the comps were higher than the company average. And then let's just land in Dallas. Dallas has seen a 54% increase in home prices since 2006 and the comp is at the company average. You can see the things are performing the way that we thought they would.

Chris Horvers - *JP Morgan* - *Analyst*

Understood. And then a couple of detailed model questions, first any comment on your expectation for the U.S. comp for the year versus the 4% total guide? And can you help us a little bit more about on the SG&A in 4Q, like you gave us 52 to 52 week comparison, perhaps how much incremental SG&A dollars there were in 4Q18 related to that 53rd week?

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

So how to go about answering those detailed questions, we don't like to give you too much quarterly information.

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

So one comment I'd make as it relates to kind of -- we are expecting positive comps in Canada for the year, if that helps.

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

The question is what happens to the U.S. dollar and we plan it currency neutral. So you can model what you think is going to happen to the dollar and do that calculation.

On the expense side, on a reported basis, because of the extra week that expense growth side on a GAAP basis looked really below it. And that's the only way to explain, it's going to look really below since we're going to move that that extra week. I think the best thing to do is just work with an annual guidance that we've given you and look at it on a 52-to-52-week basis and you get back into what the fourth quarter looks like.

Operator

Our next question comes from the line of Charles Grom with Gordon Haskett.

Chuck Grom - *Gordon Haskett - Analyst*

So the final half of the year has not been kind on the weather front, we all know that at this point. I'm just curious in the past, when you've seen this type of pattern, do you typically see the release of that demand? Or do some of the projects just get postponed or canceled altogether?

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

It's by category. So there's some categories that have the ability to extend and we're seeing that in the business right now. And so you capture that. There are some where you don't recover all of that business. You might get part of it but not all of it. So really it varies by category. So if you think about depending on when the weather takes place, you may or may not get a pre-emergent business back, for example. And this year, we didn't get that back.

Chuck Grom - *Gordon Haskett - Analyst*

Okay, great. And maybe just on the change in the comp guide. When you look ahead to your -- the long-term sales targets of \$114.7 billion directly around \$120 billion. I'm just wondering if that changes the outlook at all? Or maybe perhaps bring into the lower end of the algo equation?

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

Yes, it definitely goes to the lower end, but it doesn't change the range of guidance.

Chuck Grom - *Gordon Haskett - Analyst*

Okay, and then just one follow up on the gross margins, Carol. You -- all of last year, transportation was a pretty big headwind, you didn't call it out this quarter, I don't believe you called it out last quarter, just curious if it's actually helping you guys at this point?

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

Well it certainly has moderated from what we saw last year. What we are very excited about is the productivity that we are seeing in our upstream supply chain. Our supply chain team has done a great job of mechanizing our upstream facilities. We actually -- while I called out 2 basis points of pressure in the gross margin in the supply chain. Upstream, we leveraged. We leveraged 6 basis points. So tremendous, tremendous productivity in supply chain.

Operator

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

Zach Fadem - Wells Fargo - Analyst

Craig, you specifically called out some conservatism in your guide from the potential impact of tariffs. Curious if you could quantify the assumptions here in a little more detail, maybe talk us through how you think about the balance in the back half of raising prices and the potential downtick in volumes as a result?

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

Yes, I mean the uncertainty is what that total impact on the customer is economically overall. When we look at a specific as it relates to Home Depot, if you think about China tariffs, list 1 through 4, 4 being at 10%, that's about a \$2 billion or 2% of sales comp cost impact. So the way you have to think about tariffs is there are really 2 sides that you work on us. There is the actual cost side and there's a number of initiatives underway there, and then there's the potential of the impact to the customers as it relates to the project. And I'll let Ted talk about the cost side. We have a number of initiatives underway as it relates to how we flow things through to the customer. We use our portfolio approach. We think about this business as a project business, which it is. And there's clearly ups and downs in the elasticity but we have pretty good tools for the merchants to use on that. And we've actual been able to cover the top line. But Ted if you want to talk about the cost side.

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

Yes, I'd say on the cost side, I couldn't be happier with our partnership with the finance team, the accounting team, our assortment planning team. We have data of country of origin and potential tariff impact, literally down to the SKU. So we know exactly what are on the various list, when the tariff impacts will hit. We even know that through our retail accounting when the impact will hit in our P&L. So thank you very much to the great partnership with our finance team.

As Craig said on a macro perspective through Phase 4, Phase 4 only being at 10%, it's a potential impact of about 2% of our U.S. sales. Now with a number of activities that we're working with the merchants between negotiations with our supplier base taking into account things like currency, transfer pricing in the United States, value engineering, we are embarking upon with our suppliers, with customer backed research, if you have the marginal dollar to put into the product where you put it best, best customer value. And then were starting to see significant supply chain moves. I would say on the margin, I'm not aware of a single supplier who is not moving some form of manufacturing outside of China. So we have suppliers moving production to Taiwan, to Vietnam, Thailand, Indonesia and even back into the United States. So when you net all of that out, we see this 2-ish-percent impact being much, much less, call it something like 1%. And then as Craig said, it's up to the merchant team to work with our overall portfolio approach to the business and project approach to the business, to see how best, if at all, there we pass on any of those net impacts to our customers.

Zach Fadem - Wells Fargo - Analyst

Got it. And then on the paint category, it seems to have gotten a little more promotional so far this year. Could we talk through some of the dynamics here? What do you think has driven that elevated activity more so overall demand or whether environment and maybe also talk through your process, in deciding how you respond when you typically see changes out there in the pricing environment.

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

So first I'd answer with exterior stains. So there the weather improved and we did the reset. We've looked at last year and much more comprehensively this year, again with the #1 and #2 rated exterior stains with PPG product, we saw great performance in our exterior stains business.

On interior paint, interior paint has gotten more promotional in the marketplace. We have folks out there advertising in print and on media as much as 40% off. At Home Depot, we have, as was just released with the third party agencies, we have the absolute best paint in the marketplace. Behr paint holds the top 3 slots, ratings in 2 different surveys. And we are not going to fall into a high low promotional trap when we have the best product at the best everyday value.

And as you know in the finance community, just speaking of promotional cadence, I can remember there's a lot of talk about breaking the buck in the money market world. And we have had a 3x a year promotional cadence in paint of \$10 off a gallon and \$40 off 5 gallons in the major holidays of the year. Some of our competitors chose to break the buck and we're not going to do that.

Operator

Our next question comes from the line of Karen Short of Barclays.

Karen Short - Barclays - Analyst

Just a question on tariffs in general. So I think last quarter you commented that on price -- raising prices as it relates to tariffs impacting pricing and you initially had negative units on appliances and then demand picked up a bit. Maybe a little color on what you're seeing in terms of the consumer reaction to higher price point and then I just have a clarification question on the gross margin.

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

Yes, as we -- as I mentioned we have a number of models that we are working right now. And it varies by category. There is elasticity variance by category. And that changes over time as well. But in the work that we've done, we've been able to actually cover the total top line sales in the models that we have out there. And when you think about laundry, because we have reference that from the past, has time has gone by, laundry was actually our highest unit company category in appliances last quarter.

Karen Short - Barclays - Analyst

Interesting. Okay, that's helpful. And then on the gross margin front, obviously lumber would have been a benefit to the gross margin this quarter. Could you quantify that and walk us through how lumber may impact the gross margin in the second half?

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

I'm happy to. With a lower penetration of lumber in the second quarter, it gave us 15 basis points of margin expansion. So that was absorbed by growth in lower margin categories, like appliances as well as portable power. We love our portable power sales but we don't make a lot of money out of it.

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

And it's garden recovery in general.

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

Thank you. Absolutely, Ted. Thank you for that. So if you look at the back half of the year, we would expect lumber to stay down as we talked about, not as much as we saw in the first half, but down, which will give us some benefits for the back half as well as for the year.

Operator

Our next question comes from Steve Forbes with Guggenheim.

Steven Forbes - Guggenheim - Analyst

I wanted to revisit the tool rental business. And really when do you expect the B2B website experience to augment this initiative? And as I sort of think about it, maybe you could expand on how you view the interplay between those 2 initiatives and the potential impact to Pro engagement trends, you mentioned sort of positive but can you provide some additional color?

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

So it's a -- first comment I'll make then I'll turn it over to Ann is right now our initiatives aren't around necessarily connecting the B2B website to that from a digital experience. That will come at a later date. This is all about the investment that we're making right now in the physical locations.

Ann-Marie Campbbell - *The Home Depot, Inc.* - *EVP, U.S. Stores*

And just to support Craig on that, number one, the first thing we're doing is investing capital in the business. To your point, there is -- when we invest in fleet, we are able to drive more engagement to the Pro because we have more product available. So that's the first thing we're doing is making sure that we have the right assortment for Pro.

The number two thing we're doing there as well to drive the experience, we have had just tremendous success with the labor model we introduced in the stores last year and was able to drive higher level of engagement by having our associates at the right time to engage our customer. And so we're going to continue to lean into that. And within the tool rental area, we're also making sure that we're addressing our labor model to ensure as well that we are having a high level of engagement as well there.

And then last but not least, as we think about how do we ensure that we expand our offering and we are able to push into areas at this point to deliver the service and so forth, we are exploring hub locations for tool rental as well. So we're going to continue to push there. We're seeing tremendous growth. We're seeing higher levels of engagement, and we believe as we continue to expand it will certainly be a complement for Pros and drive loyalty within The Home Depot.

Steven Forbes - *Guggenheim* - *Analyst*

Just a quick follow up, maybe just a modeling question here, where you called out the strategic investment, dollar impact for the quarter and year-to-date. But are you still on track to expense, I think it was \$550 million for your pre-D&A for the year, or just give us an update on where you are and what the full year outlook incorporates.

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

So we are on our plan. We are on our plan for both the expense and capital in support of our strategic investments.

Operator

Our next question comes from the line of Seth Sigman with Credit Suisse.

Seth Sigman - *Credit Suisse* - *Analyst*

Carol, all the best to you. I wanted to follow up on deflation, you discussed the lumber impact, I'm just curious about net deflation, if there were any positive commodity price movements. And I guess just how you're thinking about that as part of the new full year, comp guidance?

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

So lumber deflation, I've said was 110 basis points, and then we had another 10 basis points of inflation, if you will from the other commodities category that we called out throughout from time to time.

Seth Sigman - *Credit Suisse* - Analyst

Got it, okay. And then ex the deflation, your average ticket actually accelerated in the quarter versus last quarter. So I guess outside of commodities, how do we think about the average price increase that you're seeing across the store, I guess on a same SKU basis? And then tying it in with the gross margin, to the extent that you are seeing higher retail prices, is that a benefit to the gross margin initially until the higher cost actually starts to flow through. COGS, like how do you think about that?

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

So, on the price line, I'll let Ted give details. The innovation that comes into the assortments certainly has a positive impact overall on our business as it relates to the ticket.

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

I would say from -- taking aside lumber and tariffs from a pure commodity standpoint, we had quite a bit of pressure on back half for the last year, first part of this year. That subsided, so commodity prices generally versus a year ago, if you think of steel, resin, base metals, et cetera, actually down. So that pressure on the outfit has subsided.

To Craig's point, most of our pricing increases are mix driven, in the sense that customers are trading up to more innovative, higher priced goods. We break out the components of averaging retail increase, which has increased by far the largest driver of that in Q2 as well as the past several quarters this from new product introductions, which are higher price point because of innovation. Think of cordless lawnmowers versus push gas mowers.

On tariffs, we haven't -- we have a number of tests going on in -- across the country. Nothing of any sort of magnitude, to say that we're taking price broadly at this point because of tariffs. But we are testing a number of things in these instances and taking a portfolio approach across the metric.

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

And to your question on the impact to margin, is we sell more innovative products and the customers stops themselves on the appliance structure, it drives the higher gross margin dollar. It may not change rate but it drives a higher gross margin dollar which is what the most important thing is.

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

And we're probably giving you more information than you wanted, I think it's more interesting statistic to look at the acceleration in our big-ticket here. This is the underlying sign of health of the business. This is unadjusted, big ticket grew 1.5% in May, 4.1% in June, and 5.3% in July.

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

We have time for one more question.

Operator

Our final question will come from the line of Greg Melich with Evercore.

Greg Melich – *Evercore ISI - Analyst*

Carol, thank you. Really, really helped over all the years and enjoy all the break you've got. We'll continue to annoy you as best we can. The -- I had a follow up on tariffs and inflation and then also on digital, if -- that description you gave before of list 1 to 4, does that assume a 10% tariff on everything? A 25%? Or is it 25% on list 1 to 3 and then a potential 10% on list 4?

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

Yes, that's exactly right. It's the 25% on 1 through 3 and then 10% on 4.

Greg Melich – *Evercore ISI - Analyst*

Perfect. And so to tie into that, is that a reason why inventories might have been up 5% year-over-year a contributing factor?

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

Our inventory is all about the investment that we're making in the accelerated resets for the large part though. It has nothing to do with that.

Greg Melich – *Evercore ISI - Analyst*

Got it. And then last on digital, I know, up 20%, continues to grow nicely. Is that around 9% of sales? And it did decelerate, so I'm wondering did Amazons move to next day, did you see any impact on that? And do you think that was factor in the deceleration? Or is there something else going on?

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

Yes. No, we actually were very pleased with our growth. It's 8.9% penetration in the quarter, up from 7.5% a year ago. And we've actually accelerated our capabilities in same-day delivery, Mark, I don't know if you want to share any details on that.

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

Yes, as was noted earlier, we had expanded our next-day parcel coverage. We're over 50% of our population now in next-day parcel coverage. We've expanded our car delivery also to greater than 50% out of our stores. So we're pleased with the time we're taking out of our lead time to customer. We continue to take lead time out with every move we make in the supply chain, and each time we do it, it improves conversion.

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

Just on the point on deceleration, it's a fiscal calendar shift. So that's not a comp number, that's a growth number.

Operator

Ms. Janci, we have reached the end of the question-and-answer session. I would now like to turn the floor back over to you for closing comments.

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

Thank you, Christine. And thank you, everyone for joining us today. We look forward to speaking with you on our third quarter earnings call in November.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.