

HD – Q3'20 Home Depot Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to The Home Depot Third Quarter 2020 Earnings Call.

At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation.

[Operator Instructions] As a reminder, this conference is being recorded.

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

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

Thank you, Christine, and good morning, everyone.

Joining us on our call today are Craig Menear, Chairman and CEO; Ted Decker, President and Chief Operating Officer; and Richard McPhail, Executive Vice President and Chief Financial Officer. Following our prepared remarks, the call will be open for questions. Questions will be limited to analysts and investors, and as a reminder, please limit yourself to one question with one follow-up. If we are unable to get to your question during the call, please call our Investor Relations department at 770-384-2387.

Before I turn the call over to 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 thanks for joining our call this morning. We hope that you and your loved ones are safe and healthy.

As we announced yesterday, we entered into a definitive agreement to acquire HD Supply, a leading national distributor of maintenance, repair and operations products in the multi-family and hospitality end markets. Before moving to the results for the quarter, I want to take a moment to discuss how HD Supply fits into our strategic framework.

As you know, the MRO customer is an important pro customer for The Home Depot. We are committed to better serving the MRO customer and growing in this space. The success we've had with our existing MRO business makes us confident in our ability to accelerate sales growth in the highly fragmented \$55 billion MRO marketplace.

While the transaction is subject to customary regulatory approvals, I look forward to welcoming the HD Supply associates to The Home Depot.

Richard will take you through the financing details shortly. Now let's discuss our third quarter results.

Sales for the third quarter grew \$6.3 billion to \$33.5 billion, up 23.2 percent from last year. Comp sales were up 24.1 percent from last year, with U.S. comps of positive 24.6 percent. Diluted earnings per share were \$3.18 in the third quarter.

The third quarter was another exceptional quarter for The Home Depot as we saw the continuation of outsized demand for home improvement projects. Our results were driven by broad-based strength across the store and geographies. All of our top 40 markets posted double-digit comps, while Canada posted comps above the Company average and Mexico posted its best performance since the onset of the pandemic, with double-digit comps in local currency. As Ted will detail, both ticket and transactions were up double digits in the quarter, and we saw strong double-digit growth from both our Pro and DIY customers.

As we mentioned last quarter, the step-change in the volume of business that we have witnessed over the last six months is not without its challenges, but our strategic investments, coupled with near-term actions taken, have allowed us to better serve our customers. Our third quarter performance is a reflection of this and as we continue to learn and adapt to meet the unprecedented level of demand we are seeing in the market.

Actions we have taken across our supply chain, in our stores, and in partnership with our suppliers have helped us to improve in-stock levels, reduce lead times, better manage in-store replenishment, and improve fulfillment options and delivery times. All of this has ultimately translated to over 300 basis points of sequential improvement in customer satisfaction scores for the third quarter.

Our interconnected retail strategy and underlying technology infrastructure have continued to support record level web traffic on a consistent basis for over six months. Sales leveraging our digital platforms increased approximately 80 percent versus the third quarter of last year, and approximately 60 percent of online orders were fulfilled through a store. We continue to invest in our digital assets, introducing new capabilities and different ways to engage with The Home Depot.

Over the past several months we have refreshed the digital experience in key categories and are extremely pleased with the customer response. In decorative lighting, for example, we enhanced the category experience to offer improved visual imaging and more lifestyle photos of our on-trend lighting assortment. As a result of these changes and increased marketing efforts to better highlight our offering, we have seen significantly higher customer engagement with the category online, which helped to drive sales growth above the company average in the quarter. We've also found new ways to leverage our

online platform to better showcase our assortment for events. For our Halloween event, we increased our digital offering and enhanced our presentation which resonated with our customers, resulting in the strongest customer response we've had to these events.

We are focused on continuing the momentum of our strategic investments to enhance the interconnected shopping experience and position ourselves for continued share capture over the long-term. Key components of our One Home Depot strategy, such as the opening of various supply chain facilities, technology investments and enhancements to the digital experience remain on track, and we have now restarted many of the store investments that were paused at the outset of the pandemic. Our results through the first nine months of the year clearly indicate, that for many customers, the home has never been more important. And we hear from them that they will continue to invest in home improvement through a multitude of different projects and plan to embrace the upcoming holiday season. As customers engage with The Home Depot, we see a continued blend of both the physical and digital worlds. As a result, the distinct competitive advantages and overarching benefits of an interconnected, One Home Depot strategy have never been more relevant.

I am incredibly proud of our associates for the many ways they have lived our values by serving our customers, communities and each other during these unquestionably challenging times. Our ability to grow the business by more than \$15 billion dollars through the first nine months of the year, while navigating the global pandemic and supporting our communities through multiple natural disasters, is a direct result of our associates' extraordinary efforts.

Given the ongoing demands and complexity of the current environment, we continue to focus on taking care of our people in part by extending weekly bonuses for hourly associates in our stores and distribution centers for the duration of the third quarter. Through the end of the third quarter, we have spent approximately \$1.7 billion on temporary pay and benefits in response to COVID-19.

As Richard will discuss, we have now made the decision to transition from our temporary weekly bonus program to invest in permanent compensation enhancements for our frontline, hourly associates. This will result in approximately \$1 billion of incremental compensation expense on an annualized basis. Our orange-aproned associates are the heartbeat of The Home Depot and supporting them through this time of uncertainty and beyond continues to be a key priority.

We know that we must remain agile and flexible to execute against the demands of the current environment and our third quarter performance highlights key progress we have made as we continue to learn and adapt. I could not be more proud of the resilience and strength that our associates have continued to demonstrate and I want to thank them and our supplier partners for their hard work and dedication to serving our customers and communities.

And finally, I want to take a quick moment to congratulate Ted, Ann-Marie and Jeff who are on the call with me today on their recent promotions and expanded responsibilities. Their new roles are among a number of leadership development moves we have made as we continue to invest and grow the deep bench of talent that we are fortunate to have here at The Home Depot.

With that, I would like to turn the call over to Ted.

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

Thanks Craig and good morning everyone.

I want to thank all of our associates and supplier partners for their incredible effort to serve our customers in this unprecedented environment.

The consistently strong demand we've seen over the last six months has been remarkable. For the last two quarters, we have seen comps north of 20 percent for 25 of the 26 weeks. The strong demand has pressured supply chains, and we've partnered with our supplier partners to make various improvements.

As we mentioned last quarter, the actions we took include adjusting our assortments and planograms, introducing alternative products, and in some cases, reducing the number of SKUs in certain categories to focus on the highest demand products.

In addition, we are further mechanizing our Rapid Deployment Center network and have now implemented Mechanized Floor Loading in two-thirds of our facilities, meaningfully improving our productivity in those buildings. As a result of all these actions, we have seen reduced product lead times and continued improvement in our in-stock positions. The in-stock level in our U.S. stores has improved for 12 straight weeks. While we are pleased with these results, we are not at pre-pandemic levels.

We have also re-visited customer fulfillment choices, some of which we paused earlier in the year. As a result, we are starting to re-establish premium delivery windows and express car and van delivery service that covers over 70 percent of the U.S. population.

During the third quarter, each of our merchandising departments posted double-digit comps, led by our lumber and décor & storage departments. Our comp average ticket increased 10.0 percent, and comp transactions increased 13.0 percent. The growth in our comp average ticket was driven primarily by the continuation of project demand we saw in the second quarter, customers trading up to new and innovative items, as well as inflation in certain commodity categories, like lumber.

Over the last four months, we have seen significant volatility in the pricing of lumber, as the industry works to balance supply and demand. During the third quarter, the average price for framing lumber was approximately 130 percent higher than the same period last year. As we exited the quarter, pricing for certain lumber categories had fallen from the peaks we saw mid-quarter, but still sit well above the levels we saw this time last year. Despite this significant inflation, we saw strong, double-digit unit comps in lumber in the third quarter.

During the third quarter, inflation from core commodity categories positively impacted our average ticket growth by approximately 260 basis points.

Additionally, the strength of our comp transaction growth was driven by consistently strong in-store and online transactions, continuing the same trends we saw in the second quarter.

During the third quarter, big-ticket comp transactions, or those over \$1,000, were up approximately 23 percent. We saw strong performance across a number of big-ticket categories like appliances, vinyl-plank flooring, and lumber.

During the third quarter, we saw double-digit growth with both our Pro and DIY customers. And while DIY sales grew faster than Pro sales, our Pro business posted the strongest growth we've seen all year.

As we look at our different Pro cohorts, growth with our smaller Pro customers has been consistent, with strong double-digit growth every month of the year. Growth with our larger Pro customers is healthy and accelerated from the second quarter... however, some large Pros still face headwinds related to the current operating environment, including some customers being hesitant to invite Pros into their homes.

Turning to our DIY customers... we continue to see unprecedented levels of engagement from both new and existing customers across a variety of home improvement projects. And importantly, as these customers complete a project, they are gaining the confidence to tackle their next project and re-engage with The Home Depot.

During the third quarter, we saw customers take advantage of an extended selling season for our garden and seasonal categories, resulting in significant growth in categories like hardscapes, soils, riding mowers, and outdoor power equipment. However, garden and seasonal were not the only projects our customers were working on. If we exclude our garden departments from our third quarter results, our comp was still north of 20 percent. We saw customers working on a variety of projects across their home, with categories like garage & organization, ceiling fans, vanities, and power tools all posting comps well above the company average.

The customer engagement we are seeing was also evident in our annual Halloween event. During the third quarter, we hosted our most successful Halloween event yet, with both in-store and online offerings. Customers responded to our larger assortment of animatronics, inflatables, and yard décor, as evidenced by our 12-foot giant skeleton that sold out before October, helping drive a record level of sell through for the event.

As we turn our attention to the fourth quarter, we are excited about the upcoming holiday season and believe we are in a great position for continued customer engagement. During the quarter, we will be hosting our annual holiday, Black Friday, and Gift Center events; however, this year they are going to look a little different, as we remain committed to prioritizing the health and safety of our customers and associates and promoting a safe shopping environment.

We've adjusted our Black Friday event this year to cover an extended period of time, and not just focus on one day. Additionally, for both our Black Friday and our Gift Center events, we've reorganized how we place and stage our product to assist with social distancing. For example, we've reduced the amount of product displayed on our front racetrack, and we've created more space for our Gift Center presentation. We've made deeper buys on fewer SKUs to bring great values to our customers. And, we've also included some of our core SKUs in our event, which will help with replenishment, as we continue to see strong comps.

For example... featured in our Gift Center and Black Friday events this year are exclusive power tool products from our industry leading assortment of Milwaukee, Makita, DeWalt, Ridgid, Ryobi, and more. This year we are especially excited about the launch of Ryobi 18v ONE+ HP Brushless Tools. These tools have been designed from the ground up to serve our DIY and Pro customer with more features and performance than ever. HP tools are up to 20% lighter and 30% more compact, while delivering improved power and durability with brushless motors. The Ryobi ONE+ platform has more than 100 million batteries in our customers' homes and jobsites today, and this new HP lineup brings a strong pipeline of future innovation to the more than 175 Ryobi One+ Tools in the marketplace today.

Our Black Friday & Gift Center events kicked off a little over a week ago, and we are thrilled with the early results.

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

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

Thank you, Ted, and good morning everyone. We appreciate everyone joining the call today and we hope you and your loved ones are safe and healthy.

In the third quarter, total sales were \$33.5 billion, a 23.2 percent increase from last year. Foreign exchange rates negatively impacted total sales growth by approximately \$100 million.

Our total company comps were positive 24.1 percent for the quarter, with positive comps of 21.8 percent in August, 27.8 percent in September, and 23.0 percent in October. Comps in the U.S. were positive 24.6 percent for the quarter, with positive comps of 22.6 percent in August, 28.5 percent in September, and 23.0 percent in October. Our comps in August and September of this year were impacted by a shift in our Labor Day event. This year, our Labor Day event fell in fiscal September, and last year it fell in fiscal August. If we adjust for this shift, our monthly comps in the U.S. would be 24.7 percent in August, and 26.4 percent in September.

All 19 of our U.S. regions, as well as Canada and Mexico posted double-digit positive comps in local currency.

In the third quarter, our gross margin was 34.2 percent, a decrease of approximately 30 basis points from last year. Gross margin was negatively impacted during the quarter by several factors, including product mix and pressure from shrink. Mix pressure from lumber alone, negatively impacted gross margin by approximately 35 basis points in the third quarter. The decline in gross margin was partially offset by the benefit of reduced promotional events during the quarter.

During the third quarter, operating expenses were approximately 19.7 percent of sales, representing a decrease of approximately 30 basis points compared to last year. Let me take a moment to comment on a few of our expense items.

- First...during the quarter we continued to support our associates with enhanced benefits in response to COVID-19, which totaled approximately \$355 million, resulting in approximately 105 basis points of expense deleverage;

- As you heard earlier from Craig, through the end of the third quarter, we have spent approximately \$1.7 billion on enhanced associate pay and benefits in response to COVID-19. We've also made the decision to transition from our temporary weekly bonus program to permanent compensation enhancements for our frontline, hourly associates. This will result in approximately \$1 billion of incremental expense on an annual basis. We began making these adjustments in the third quarter and will continue to make the majority of them in the fourth quarter on a market-by-market basis.
- Second...we incurred approximately \$60 million of operational COVID-related expenses, including personal protective equipment for our associates and customers, and enhanced cleaning of our stores, resulting in approximately 20 basis points of operating expense deleverage;
- Third...we recorded expenses related to our strategic investment plan of approximately \$325 million, an increase of approximately \$48 million compared to last year;
- And finally...during the third quarter, we showed strong expense control in other areas of the business and drove approximately 155 basis points of expense leverage.
 - Included in this 155 basis points of leverage is approximately 70 basis points of pressure driven by accrued bonus expense primarily related to our current outperformance for our bi-annual store-success-sharing program and store and field based management bonuses for the second half. The success sharing and store and field-based management bonuses are in addition to the \$1.7 billion of enhanced pay and benefits in response to COVID-19.

Our operating margin for the third quarter was approximately 14.5 percent, flat with the same period last year.

Interest and other expense for the third quarter grew by \$49 million to \$329 million, due primarily to higher long-term debt levels compared to one year ago.

In the third quarter, our effective tax rate was 24.1 percent, compared to 24.5 percent in the third quarter of fiscal 2019.

Our diluted earnings per share for the third quarter were \$3.18, an increase of 25.7 percent compared to the third quarter of 2019.

At the end of the quarter, merchandise inventories were \$16.2 billion, an increase of \$444 million versus last year, and inventory turns were 5.9 times, up from 5.0 times from the same period last year.

Moving on to capital allocation. Our long-term principles for how we think about deploying capital have not changed. After investing in the business, it is our intent to return excess cash to shareholders through a balanced approach of paying a healthy dividend and through share repurchases.

Let's take a moment to talk about our first priority. We are committed to reinvesting in the business to drive growth faster than the market...and the acquisition of HD Supply strategically positions us to drive accelerated sales growth in a highly fragmented MRO space.

Under the terms of the merger agreement, a subsidiary of The Home Depot will commence a cash tender offer to purchase all outstanding shares of HD Supply common stock for \$56 per share, for a total enterprise value, including net cash, of approximately \$8 billion. The closing of the tender offer is subject

to customary closing conditions, including regulatory approvals and the tender of a majority of the shares of HD Supply common stock then outstanding, on a fully diluted basis, and is expected to be completed during The Home Depot's fiscal fourth quarter, which ends on January 31, 2021.

We plan to finance the acquisition with cash on hand and new debt. We also expect the transaction to be accretive to EPS in fiscal 2021, with potential for significant shareholder value creation over the longer term.

During the third quarter, we invested approximately \$470 million back into our business in the form of capital expenditures and paid \$1.6 billion in dividends to our shareholders.

Computed on the average of beginning and ending long-term debt and equity for the trailing twelve months, return on invested capital was approximately 41.6 percent, down from 45.1 percent in the third quarter of fiscal 2019. This decrease primarily reflects our decision to temporarily enhance our liquidity position including the suspension of our share repurchase program back in March.

Turning to the macro environment...the strong demand we've seen has continued. Comps have slightly accelerated in the first two weeks of November, reflecting an earlier start for our Black Friday and holiday events versus last year. We are encouraged by consumer sentiment and consumption trends, which show home improvement receiving more than its historical share of consumer spending. Housing metrics are significantly stronger than when we entered this crisis. Turnover is rising, we see continued growth in household formation and home prices are appreciating as inventory on the market hovers near record lows. Our customers tell us their homes have never been more important, and they intend to continue their investment in the improvement of their homes.

While the current demand environment is strong, it is important to remember that we are not through the COVID-19 pandemic and we do not think it is prudent to extrapolate recent trends to predict future performance. Our main focus remains on meeting our customers' needs while prioritizing safety. And we believe that the investments we have made over the last several years have uniquely positioned us to capture market share regardless of the environment.

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

QUESTION AND ANSWER

Operator

(Operator Instructions) Our first question comes from the line of Christopher Horvers with JP Morgan. Please proceed with your question.

Chris Horvers - JP Morgan, Analyst

So I know you mentioned about the slight acceleration quarter-to-date, but I was wondering if what you've seen in areas where COVID cases have spiked, what do you think the business looks like as it gets colder and outdoor DIY gets tougher? You mentioned the low-20% ex-garden comp. Do you think that's a good proxy for the underlying trend? Would you expect the large Pro to continue to improve and provide a benefit?

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

So, Chris, first comment would be we see no correlation in the business as it relates to COVID cases. I mean, our performance overall was actually really tight geography-wise, and we saw broad strength across the store. So as Ted mentioned, we had an extended season because of the weather in garden, but we were extremely pleased with the performance outside of our outdoor categories. So we feel good about that, and we've seen the Pro continue to recover and the large Pro recover.

Chris Horvers - *JP Morgan, Analyst*

Got it. And then a couple of follow-up questions on the investment outlook. It sounds like you're making progress on the store investments again. Will you end up on track versus the original plan? And what do you think about the degree at which investment dollars and SG&A are down year-over-year in '21 -- year-over-year in 2021? And then now that you have HD Supply, I was curious, how many of the 150-or-so new buildings that you've planned to build under the current investment plan related to the MRO? And does the acquisition of HD Supply impact the outlook for the -- building those buildings and CapEx related to that?

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

So with respect to the investment outlook, as we've said in the past, we have deferred certain investments that principally relate to investments made inside the store. A large number of those investments remain deferred.

We started the year with a CapEx plan of approximately \$2.8 billion. We have deferred less than \$0.5 billion. And so while I won't give you an exact number, I would say we will see deferral of, call it, \$300 million to \$400 million from our original plans in 2020. Some of that may push into 2021, and we'll update you as time goes on. But I would say that overall, 2021 is going to be very similar to 2020 in terms of CapEx.

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

And as it relates to the HD supply asset base in total, obviously, we'll take a look at that, and we'll evaluate the combined asset base once this gets approval. And we'll move forward with what we think the best leverage point is to serve our customers and grow in the MRO space, which is a \$55 billion fragmented market that we're pretty excited about.

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

And if I could just take a minute, Chris, on what we've accomplished. While we did push a bit into 2021, we're just thrilled that we are finishing the investment in our new look and feel of the store. Our sign packages will be done in all U.S. stores this year. I think that is probably the first time the brand standard across all the United States stores has been the same, maybe since our first 2 stores opened in 1979.

We've completed all our self-checkout refreshes. We've added storage to most of our stores for online pickup. We've implemented electric sign -- electronic sign labels in all our appliance departments. Completely refreshed our paint -- color wall experience in our paint department. We've completed the

tool corral by brand standards in those leading brands in our tool business. And we've also taken that to our outdoor power equipment, and we'll be done early next year, resetting all our outdoor power equipment, again by those battery platforms that are leading brands in the industry.

So we've completed a ton of work despite some of the setbacks with COVID this year. The team just did a terrific job getting all that work done.

Chris Horvers - *JP Morgan, Analyst*

So then, Richard, I know you mentioned CapEx deferring in... But I think originally '21 was, from an OpEx perspective, so source of funds, incremental investment dollars down year-over-year versus being up the past few years. Do you still expect those investment dollars in OpEx to be down in '21?

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

They'll be flat/down in '21, those specific expense dollars with respect to the investment program that continue alongside the deferred spend in '20.

Operator

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

Scot Ciccarelli - *RBC Capital Markets, Analyst*

So you did talk about product mix as the primary factor for the gross margin decline. Was there much of an impact on gross margins from channel mix as e-commerce has outpaced store growth? Or was it really all on the product side? Or were there any other factors we should be mindful of?

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

Nothing in particular, Scot. By far, the big driver was the lumber penetration, the lumber mix as strong as that business was.

Scot Ciccarelli - *RBC Capital Markets, Analyst*

So as we -- just thinking about this kind of going forward, Ted, should we think about if we wind up seeing any more normalized mix kind of getting back to, let's call it, flattish kind of gross margins, is that the right way to think about it from a cadence perspective?

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

I think at this point, with the level of uncertainty in the environment and the dynamics in the business today, we wouldn't give any forward expectations with respect to margin. We're running a very healthy business. We run it on a portfolio basis.

When you -- you bring up channel mix, we run this as a portfolio and have for many, many years, and you've seen the stability in our gross margin that reflects that. Remember that over 60% of sales that are

purchased on our digital assets are picked up in the store and have an identical mix, in essence, to our store mix. So that's where we stand. We're very comfortable with the mix of business we see.

Operator

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

Michael Lasser - UBS, Analyst

There's a lot of moving pieces with Home Depot's longer-run earnings power between any changes in consumer behavior, the incremental costs that you're paying your associates, the acquisition of Home Depot Supply, channel mix, so relative to the 14% operating margin expectation you put out previously, recognizing that the sale expectation you're not providing longer-run guidance, do you think the business can now earn a higher, lower or about the same margin knowing what you know today than what you had thought previously?

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

Well, I'd say a lot is dynamic, but many things stay the same. I think we have executed exceptionally well in terms of expense management throughout the year. And I think you can expect that from us in the future.

I think one thing I will just make sure that we clarify is how the shape of our investments to support our associates goes from 2020 into '21. So as we said, our expenses through the first 3 quarters of the year in support of our associates totaled approximately \$1.7 billion. We are transitioning the nature of those investments into permanent wage investments during the fourth quarter.

So if you think about the fourth quarter, we're not going to quite be down to that \$1 billion annualized run rate as some of these programs leak into the beginning of the fourth quarter. We will be lower than the third quarter run rate. But add it to \$1.7 billion and say that 2020 will likely end at a total of \$2 billion of investments in our associates. Of that \$2 billion, only \$1 billion will remain in our cost base in 2021. So I think that's the most important fact with respect to our cost base that I'd like to make sure we clarify.

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

And Michael, the only other comment I'd add to that is everything that we've been doing through our investment program is to try to position The Home Depot to grow faster than the market on a consistent basis no matter what the operating environment is and to deliver incremental op margin dollars as a result. That's our focus. That's what we're trying to get done.

Michael Lasser - UBS, Analyst

Craig, that's a good segue to my second question, which is recognizing that it's very hard to prognosticate how demand for overall home improvement is going to shape up next year, if you had to make an estimate, what percentage of your categories or your SKUs do you think you'll be ordering inventory down next year?

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

Look, we -- first of all, the inventory planning for The Home Depot is on a very short cycle. We plan really week to week. We release orders every single day. And 70% of what we purchase is domestic goods and comes from short lead time-type performance. So we'll manage that on a day-by-day, week-by-week basis based on what we see in demand. And really not looking -- we're not looking to extrapolate anything at this point from current performance. Our whole focus is on being able to be flexible and agile and adjust accordingly.

Michael Lasser - *UBS, Analyst*

Okay. I guess the heart of the question was do you think home improvement demand is going to grow next year?

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

So look, the only thing I can tell you at this point is when we talk to our customers and we do work on surveys, the customer tells us that the home has never been more important. Maintenance in the home is going up as people spend way more time in their home. And they tell us -- there's a significant percentage of folks that say they're going to do a project within the next 6 months. And so everything that we see at this point in terms of customer feedback would suggest they're going to continue to invest in their homes.

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

At the same time, there's a lot of uncertainty in the environment. There are macroeconomic fundamentals that we're all going to be subject to. And so I think if you think about it on a comparative basis, as Craig said, home improvement is a great space to be in at the moment. And as customers -- it's interesting, you look at the housing dynamics and you say, when customers see their home price appreciate, they tend to invest more in their homes. Again, we're guarding our comments because of the uncertainty in the macro environment. And so at this point, we really can't comment on '21, but we do think there's a lot of confidence with respect to home improvement in our customers' minds.

Operator

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

Karen Short - *Barclays, Analyst*

Just a couple of questions. I guess I'm wondering with respect to your inventory, following up on Michael's question, do you actually think you'd maybe lost sales with the inventory that was a little too lean? And then wondering how to think about inventory for the fourth quarter. And then the second question I had is just you obviously have more and more information on your DIY customer than you have for the last several quarters given the e-comm penetration. I'm wondering if you could give a little more color on what the general demographic has -- is looking like now, and what the biggest shifts or changes that you've seen from an, I guess, age or income cohorts?

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

On inventory, Karen, it would be hard to gauge some of the lost sales opportunity. That would have likely been more of a Q2 impact for us because we did go in with a little more conservative approach when the pandemic hit. As you know, we limited customer hours, limited customer counts and we also pulled back a bit on inventory.

Since that time, though, between the merchandising team and the supply chain team and the sourcing teams and transportation team, they really have just done an incredible effort flowing product into the store. And as I said in my prepared remarks, we improved in-stock levels every week of the quarter. Our inventory grew over \$400 million from the prior year. That was our first year-over-year increase that we had seen this year. And in pure volume, if you look at our accounts payable, that gives you an indication of how much goods we have flown into the buildings. It's over \$3 billion from our low point.

So the in-stocks still are not exactly where we'd like them to be, but incredible improvement. And the work the merchants have done, even though the in-stocks still have some ways to go, by working on the right SKUs with our supplier partners, updating planograms and the like, we're -- we believe we have the product and the type of items in the store that our customers are looking for.

As it relates to online trends, you're absolutely right. Our online business, we couldn't be happier with the performance of our digital assets. And remember, we are an interconnected business. So with everything I'm about to say, remember that over 60-odd percent of our goods are picked up in our store. Nonetheless, our interconnected business grew by 80%. The penetration was 13% to the business. The sales, that translates to nearly \$2 billion of sales growth in the quarter for our online business.

Our visits are up dramatically. We're up in mobile, desktop, mobile web. Our conversion is up despite the hyper growth in app and mobile web that tend to have lower conversion rates than desktop. Our app downloads are way up. Our active app users are way up. Our orders are up. Our My Account, these are folks who are setting up an account with Home Depot, so obviously we know them better when they set up an account, are way up.

Millennials are highly engaged with The Home Depot. You asked about customer profile. Our Pros are highly engaged. Our B2B website is seeing record volumes and engagement with our Pro customer. So I'll stop there, but it is a robust interconnected digital environment right now at The Home Depot.

Operator

Our next question comes from the line of Kate McShane with Goldman Sachs.

Kate McShane - Goldman Sachs, Analyst

I know there -- you gave your comments on HD Supply, but I wondered if there was any more color you could give on the source and magnitude of any synergies? And how much debt might be taken or raised for the deal?

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

We're really excited about what the combination of these 2 MRO businesses will bring to our customer. We think we've got the opportunity to create significant shareholder value creation through that combination. We're not going to talk about the degree of accretion, but confident that we'll see earnings per share accretion in 2021.

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

Kate, what we're excited about is if you -- these are rough numbers. If you think about 130 million occupied households in the United States, about 80 million of that is kind of owned household single family. There's 50 million, and that is rental. And of the 50 million, about 30 million, give or take, is in kind of the multifamily operations-type business.

That is a huge opportunity for The Home Depot to continue to grow not only on the MRO side, but as we build relationships with customers on the MRO side, we build relationships to be able to participate in capital refreshes of those facilities as well, which is something we're pretty focused on. So we're super excited about the opportunity that comes with this MRO space.

Kate McShane - *Goldman Sachs, Analyst*

Okay. And I wondered if I could ask an unrelated follow-up question. Just regards to your seasonal business that you do in the fourth quarter, is there any way to dimensionalize or size how big of a business that is becoming for you in the fourth quarter?

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

I'm trying to remember off the top of my head. We always -- we talked about seasonal breakout of outdoor categories. The fourth quarter is the lowest of the year, right, Ted?

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

Yes. So generally, it's been shifting a little bit this year given the extended garden season and as engaged as customers have been. But usually, think of Q4 as low 21-ish percent penetration of what we would deem outdoor business. And that very much is the low point with Q2 traditionally being the high point, think of mid-30s. So that's sort of the range of changes in the business.

Operator

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

Simeon Gutman - *Morgan Stanley, Analyst*

First, a question for Richard. You mentioned a few macro factors, and I'm trying to extrapolate. It sounds like you're a little bit more bullish on those than maybe you were in prior calls. Can you give us any sense -- I know you said directionally getting better. Can you give us a sense of what these inputs could look like for 2021 just in terms of magnitude, whether it's home price appreciation, housing turnover, et cetera?

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

So in my earlier comments, I said we're really pleased with the current level of consumer sentiment and consumption in the economy. I'm not going to make a prediction on where those macroeconomic levers go in the future.

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

I mean the other thing, Simeon, that I would say is I think the last number I saw is somewhere in like the 2.7 months of supply in housing. And the historical average on that is 6 months, so you'd have to believe that's going to continue to hold up home values. And I think home value improvements have been the surprise this year.

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

It's -- I think it's a positive housing environment. We're not extrapolating that into expectations for sales principally because of the uncertainty in the macro environment. So we are optimistic and current conditions are certainly favorable for home improvement, but there is uncertainty. We'll learn a lot in the fourth quarter.

Simeon Gutman - *Morgan Stanley, Analyst*

Okay. Fair enough. And then my follow-up, based on the results by customer type, right, the Pro customers coming back, can you talk about the backlog that you're seeing? Are you seeing the jobs that are coming back to normal, indoor jobs? And I think it may have been asked earlier, but the transition from outdoor to indoor as how is that taking place?

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

So Simeon, you're right. The Pro has been coming back. We see double-digit comps in Pro. We did last quarter as well. Small Pro is leading the large Pro. We've seen that large Pro really strengthened in the larger metro markets. In our services business, if you look at that as a benchmark to Pro's business, we have one of the larger backlogs of to-be-installed sales jobs that we've ever seen.

And as you'd imagine, a lot of this is special ordered goods. So getting the bespoke special order made and shipped to the particular job and then getting the labor to install that job continues to be a bit of a pressure and more so in certain markets, leading to that large backlog. But if what we're seeing in our services business translates to what the larger Pros are also seeing, that would be sizable backlog.

Operator

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

Chuck Grom - *Gordon Haskett, Analyst*

Can you talk about where you are in the supply chain buildout that you've outlined over the past few quarters, and maybe how much of a delay COVID caused and the degree to which you can make that up in '21?

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

Sure. I just -- largely, COVID hasn't had a big impact. And I'll let Mark comment on where we are.

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

Yes. Mark Holifield here. Yes, we've continued to open facilities through the pandemic. I've been incredibly impressed that the team has been able to keep our program on track in terms of the One Supply Chain initiative. In Q3, we opened up about 11 MDOs. We now have 3 -- those are market delivery operations. We now have 3 flatbed delivery centers open, and we've got a very solid pipeline for '21 that we're working. And so we're very much on track with the One Supply Chain initiative.

Chuck Grom - *Gordon Haskett, Analyst*

Okay. That's great. And then just maybe one for Richard. You spoke a lot over the past year about the ongoing margin headwind from shrink. And I realize maybe you've been limited in your ability to do some of the inventory, the physical inventories. But I guess, where are we in that life cycle? It seems like it was an issue again here in the third quarter. Any line of sight of when you think the shrink flips from -- could flip from a negative to a positive?

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

Well, at the beginning of the year, we said that impacts from our initiatives weren't really going to be seen until the year 2021. It takes time to roll these out. We did anticipate at the beginning of the year that we would see pressure from -- on a year-over-year basis. The results through the third quarter have been essentially consistent with our original expectations.

Operator

Our next question comes from the line of Michael Baker with D.A. Davidson.

Michael Baker - *D.A. Davidson, Analyst*

A couple. One, Halloween being strong, does that typically act as a leading indicator for Christmas or even Thanksgiving? In other words, if people are buying the big blowups for Halloween, does that translate into big Christmas or I don't know [if you do] a big Thanksgiving business on that, but does that translate at all to what we should expect in the fourth quarter?

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

I think what we saw in the Halloween business probably is more correlated to what we've historically seen in storm markets. When you have a hurricane hit -- our thinking years ago was that, oh, geez, we

needed to pull back on all that kind of product because that wouldn't be where the customer focus was, and we needed the space for rebuild-type product. And what our customers told us was, "No, actually, we're looking for some kind of normalcy. And we actually want to buy that product from you."

And I think that's exactly what we anticipated and are seeing through the holiday programs as Halloween was the strongest event we've ever had. So we had anticipated in the beginning of the year -- because that's a long-cycle product that you purchase well in advance, we had anticipated that the customer would want to engage in holiday and purchased accordingly.

Michael Baker - D.A. Davidson, Analyst

And so do you have that same expectation for Christmas? Did you purchase that similarly?

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

Yes, that's what I mean. We bought into the whole holiday decor for the entire season, Halloween all the way through Christmas, because we anticipated that customers are going to want some kind of normalcy in their life.

Ted Decker - The Home Depot, Inc. - President & COO

The holiday set has been set now for Christmas for several weeks in the store now. And as I said, we're very pleased with the early engagement and sales in the program.

Michael Baker - D.A. Davidson, Analyst

Yes. Got it. Understood. If I could ask one more follow-up on the Home Depot Supply. Thinking back a few years to an Analyst Day that you had, I think you implied that you -- or said that your share in MRO was about 5%, which would have implied about \$2.5 billion, and then we add on 3 plus for Home Depot Supply. You're getting above \$5 billion about 10% share. Is that the right way to think about it?

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

We think it's about a \$55 billion market that we play in with the combination of our current MRO business and what will be added with HD Supply.

Michael Baker - D.A. Davidson, Analyst

And what do you think your share is of that \$55 billion?

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

We won't speak on HD Supply's financial information. The transaction hasn't completed yet. We'll refer you back to theirs. But as Craig said, call ours roughly \$2 billion.

Operator

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

Zack Fadem - Wells Fargo, Analyst

So with your digital sales up 80% in the quarter, I think that would imply that your in-store sales accelerated in Q3. And I'm curious if you would attribute this more so to the impact of easing some of the early COVID restrictions on stores? Or do you think there are other factors like better in-stocks or incremental demand from Pro customers that you would call out?

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

I think it's all of the above. I think we learned how to better operate. We ended up turning control of constraints in stores over to our store managers who are closest to the situation on the ground versus a company-wide approach. We did that at roughly the beginning of the quarter.

We improved our in-stock position, as Ted indicated. We saw overall improvement with our Pro customers. And our smaller Pros have been steady, our larger Pros improved, yet there's still opportunity for them. And we saw our services business improve overall. So I think there's a number of factors that led to this performance in the quarter. So we're pleased with the trends that we're seeing in the business right now.

Zack Fadem - Wells Fargo, Analyst

Got it. And then lastly, on the decision to reacquire HD Supply. Could you talk about why you think the timing makes the most sense now, particularly with some of their end customers like hospitality and facilities impacted due to COVID? And on the strategic investments, curious how you would think about prioritizing that incremental investment dollar across the MRO business relative to your existing strategic plans.

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

Look, I'd say a couple of things. First of all, over a period of time, the HD Supply business came down to essentially the MRO maintenance facility business that it is today that we just put the offer in on. And so it strategically lines up with what we're trying to get accomplished in the MRO business, much more so than it did a few years ago. So from a timing standpoint, that's the logic there. And look, we look forward to – as we close this deal, hopefully during our fiscal year-end here, then we'll determine the go-forward approach and how we allocate and prioritize. But we got to get this deal closed first.

Operator

Our final question comes from the line of Steven Forbes with Guggenheim.

Steven Forbes - Guggenheim, Analyst

I was hoping to maybe expand on the compensation enhancements for the hourly associates. I don't know if it's possible, Richard or Craig, if you could discuss whether the investments are concentrated in absolute wage rates or if there's other sort of aspects of the compensation or benefits that are being changed as we think about the cost structure going forward.

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

Now, look, Steven, we believe that our associates are a competitive advantage to The Home Depot, and they're critical to the overall customer experience. And this investment is essentially in wage. And as we do everything as it relates to our associates, that's done on a market-by-market basis overall. But yes, you can think of it as largely -- it's wage.

Steven Forbes - *Guggenheim, Analyst*

And then as a follow-up to that, I mean, should we expect any incremental pressure stemming from higher implement cost for the full-time associate pool? Or maybe as -- I don't know if you could sort of discuss, right, is the best way to think about 2021, Richard, you mentioned \$2 billion transitory versus \$1 billion permanent. But are there any other potential cost factors we should be considering in our models as it pertains to the full-time pool?

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

It's all of our frontline associates, essentially. Whether they're full time, part-time, doesn't matter.

Operator

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

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

Thank you, Christine, and thank you, everybody, for joining us today. We look forward to speaking with you on our fourth quarter earnings call in February.

Operator

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