HD - Q2 2015 Home Depot Inc. Earnings Call
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PRESENTATION

Operator

Good day and welcome to The Home Depot second-quarter 2015 earnings call. Today's conference is being recorded.

(Operator Instructions)

At this time I would like to teleconference over to Ms. Diane Dayhoff, Vice President of Investor Relations.

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

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

Following our prepared remarks the call will be open for analyst questions. Questions will be limited to analysts and investors and as a reminder we would appreciate it if the participants would limit themselves to one question with one follow-up please. If we are unable to get to your question during the call please call our investor relations department at 770-384-2387.

Now 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 may also include certain non-GAAP measurements. Reconciliation of these measurements is provided on our website.

Now let me turn the call over to Craig.

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

Thank you, Diane, and good morning everyone. Sales for the second quarter were $24.8 billion, up 4.3% from last year. Comp sales were up 4.2% from last year.

Diluted earnings per share were $1.73 in the second quarter and our U.S. stores had a positive comp of 5.7%. For the first half, sales grew over $2.2 billion, or 5.1% exceeding our plan even in the face of a stronger U.S. dollar.

We were pleased with this quarter's performance. All three of our U.S. divisions exceeded their sales plan with mid to high single-digit comps and all of our 19 regions and top 40 markets also posted positive comps in the quarter.

We had a record number of transactions this quarter and our highest quarterly average ticket going back to 2006. As Ted will detail the core of the store continues to perform well.

Our objective is to create balance in our business. During the quarter we continue to see growth in DIY and heavy pro categories as well as our installation services business.

During the quarter we announced recent actions taken to further invest in growing our pro business. We remain focused on addressing the needs of the pro customer through helping them build a better business. This includes providing solutions to the pro in our stores and also at the jobsite.

During the quarter we reached an agreement to acquire Interline Brands, a leading national distributor of maintenance repair and operations or MRO products. Interline's expertise and hospitality, multifamily and institutional MRO brings strong fulfillment and sales capability to The Home Depot and the residential MRO product market. We believe that we can leverage their capabilities to expand our share of wallet with our current customers as well as gain new customers currently served by Interline.

We also named Bill Lenny a 20-year-plus Home Depot veteran to lead our newly formed outside sales and service team. Through aligning our pro MRO and installation services functions we believe we can better serve our pro and consumers through a more streamlined and focused approach. I'd like to congratulate Bill on his promotion and also look forward to welcoming the Interline team into the Home Depot family as we plan to complete the acquisition in the third quarter.

Internationally our Mexican business had another quarter of solid performance with positive comps in local currency for the 47th consecutive quarter. And our Canadian business also posted positive comps in local currency making it 15 consecutive quarters of positive comps.

We remain on a journey to build out interconnected capabilities to meet the customer's changing needs. We had another quarter of strong growth in our digital assets with dotcom sales growing approximately 25% led by online orders picked up in the store through Buy Online, Pick Up In Store, BOPUS, and Buy Online, Ship to Store, BOSS.

At the same time our operations team remained focused on improving the interconnected customer experience in the store. And as a result we saw another quarter of year-over-year improvement in customer satisfaction scores for our BOPUS and BOSS offerings in the second quarter.

Our dotcom team continues to expand our capabilities to solve our customers' needs through our online properties. During the quarter we improved our mobile experience, invested in content and made site improvements to take friction out for our customers. Our online channel represented 5% of sales in the second quarter.

We're investing in our supply chain as well to support our online growth. Mark Holifield and our supply chain team completed the build out of and have begun to receive product in our third direct fulfillment center or DFC located in Troy Township, Ohio.

We will begin shipping product to customers out of this facility in the third quarter. This facility along with our two other DFCs in California and Georgia will give us the capability to reach 90% of our U.S. customers with two-day or less parcel shipping.

We're pleased with the performance in the first half of the year. And while 2015 consensus U.S. GDP growth projections are moderate, housing data remains supportive of the continued growth in home improvement industry. As Carol will detail, we are increasing our sales and earnings per share guidance for the year to reflect the out-performance of the quarter and the expected benefit from the anticipated completion of the Interline acquisition in the third quarter.

Let me close by thanking our associates for their hard work, dedication and commitment to our customers. Based on this quarter's results, over 99% of our stores qualified for our first-half Success Sharing, our profit-sharing program for our hourly associates.

And with that let me turn the call over to Ted.

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

Thanks, Craig, and good morning everyone. We were pleased with our performance in the second quarter as we saw continued strength across the store. The departments that outperformed the Company's average comp were appliances, tools, plumbing, decor, lighting, kitchen and bath, hardware and flooring.

Millwork building materials, indoor garden electrical, lumber and paint were positive but below the Company average. Outdoor garden was slightly negative.

Pro heavy categories continue to show great strength. And we saw double-digit comps in water heaters, power tools, commercial lighting, flooring tools and materials and power tool accessories. In addition siding, builders hardware, compressors, boards, gypsum, fasteners, concrete and insulation had comps above the Company average.

The core of the store continued to perform as well as we saw strength in maintenance and repair categories. Air circulation and hand tools had double-digit comps while cleaning, wiring devices, circuit protectors, plumbing repair parts, pipe and fittings and lightbulbs all had comps above the Company average.

In decor categories tile, in-stock kitchens, recessed lighting, bath fixtures, vanities, ceiling fans, faucets, interior lighting and bath accessories also had comps above the Company average.

Once again our events delivered strong sales with the Memorial Day and Fourth of July events leading the way. Our customers responded to great values which drove double-digit comps in appliances led by cooking, dishwashers and refrigeration.

Outdoor project categories like soils and mulch, live goods and fertilizers were pressured during the quarter, specifically from weather that impacted certain areas of the country like the drought in California and record rainfall in parts of Texas and the Midwest.

Total comp transactions grew by 2.5% for the quarter while comp average ticket increased 1.7%. On top of the impact of a stronger U.S. dollar, our average ticket increase was negatively impacted by commodity price deflation mainly from lumber, copper and building materials. The total impact to ticket growth from commodity price deflation was approximately negative 19 basis points.

Transactions for tickets under $50 representing approximately 20% of our U.S. sales were slightly positive in the second quarter and reflect the negative weather impact to outdoor project categories like live goods. Transactions for tickets over $900 also representing approximately 20% of our U.S. sales were up 6.3% in the second quarter. The drivers behind the increase in big-ticket purchases were appliances, water heaters, windows and riding mowers.

Our journey in merchandising transformation continues. Utilizing our regional merchandising managers and our planning and assortment tools we recently refined our assortment in cleaning.

Based on customer demand and analytical data we expanded our offering in the category. In addition to refreshes and subcategories like sponges, gloves and brooms we expanded our air care and laundry offering and are very pleased with the results.

Now let me turn our attention to the third quarter. We have an exciting lineup of exclusive new products for our pro customers led by the 20-Volt Max sliding miter saw from Dewalt. This innovative miter saw features the integrated XPS crosscut system that allows for enhanced position in a variety of cutting jobs. It is compact and lightweight allowing for easy transport and storage which will save our pros time and money on the jobsite.

New from commercial electric is the LED Smart Down light. This easy to install recessed light system is linked enabled and the color temperature of the lights can be wirelessly controlled through a mobile device. This is the first color tuning smart LED Down light of its kind and it is exclusive to The Home Depot.

For our DIY customer we are pleased to introduce an exclusive carpet assortment called Lifeproof featuring textured, twist, looped and pattern styles. This innovative carpet has lifetime stain protection and can withstand common household spills including ketchup, red wine and even soy sauce. It offers superior softness, exceptional durability and is perfect for families with children and pets.

In addition to all the great new products we're excited about our upcoming events. The fall season and cooler temperatures are just around the corner and we have an incredible lineup of great values and special buys for our customers during our Labor Day, Fall Cleanup and Halloween Harvest events.

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

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

Thank you, Ted, and hello everyone. In the second quarter sales were $24.8 billion, a 4.3% increase from last year. Versus last year, a stronger U.S. dollar negatively impacted total sales growth by approximately $365 million, or 1.5%.

Our total Company comps or same-store sales were positive 4.2% for the quarter with positive comps of 2.6% in May, 3.6% in June and 6.1% in July. Comps for U.S. stores were positive 5.7% for the quarter with positive comps of 3.5% in May, 5.1% in June and 8.2% in July. Our total Company gross margin was 33.7% for the quarter, an increase of 6 basis points from last year.

The change to gross margin was driven by multiple factors. First, we had 27 basis points of gross margin expansion in our supply chain due primarily to increase productivity in our distribution network and lower fuel costs. Second, we had 6 basis points of gross margin expansion from lower shrink due to operational enhancements. Finally, we had 27 basis points of gross margin contraction due primarily to a change in the mix of product sold and some commodity price deflation.

For fiscal 2015 we continue to expect our gross margin rate to be about the same as what we reported in fiscal 2014.

In the second quarter, operating expense as a percent of sales decreased by 15 basis points to 19%. Our second-quarter expenses include $153 million of gross expenses incurred as part of our data breach, the majority of which were for an accrual for estimated probable losses that we expect to incur in connection with claims made by the payment card networks.

Our net breach-related expenses after insurance were $92 million. Excluding the net breach-related expenses, our expenses grew at 35% the rate of sales growth, better than our plan, reflecting solid expense control and sales leverage.

One more comment on our breach-related expenses. Beginning in the third quarter of last year and through the second quarter of this year, our gross breach-related expenses totaled $232 million and our net breach-related expenses after claiming reimbursement from our $100 million insurance policy were $132 million. Looking ahead we expect to have some ongoing expenses related to the breach.

Our operating margin for the quarter was 14.7% and for the first six months of fiscal 2015 was 13.7%. Interest and other expense for the second quarter was $84 million, down $107 million from last year.

The year-over-year change reflects two items. First, interest and investment income increased by $132 million, due primarily to a pretax gain of $144 million on the sale of HD Supply common stock as during the quarter we liquidated our

remaining position in HD Supply. Second, interest expense increased by $25 million from last year due primarily to higher long-term debt balances. At the end of May, we raised $2.5 billion of new senior notes.

In the second quarter our effective tax rate was 37.3% and we expect our income tax rate to be approximately 36.5% for the year. Our diluted earnings per share for the second quarter were $1.73, an increase of 13.8% from last year. Our diluted earnings per share for the second quarter included a $0.07 benefit related to the gain on sale of HD Supply common stock as well as a $0.05 detriment related to the net expenses incurred as part of the data breach.

Total sales per square foot for the second quarter were $420, up 4.1% from last year. And at the end of the quarter inventory was $11.9 billion, up slightly from last year but that's a bit distorted due to a stronger U.S. dollar.

On a currency neutral basis inventory dollars were up approximately $435 million. Inventory turns were 5.1 times compared to 4.9 times last year. Payables were up $330 million from last year but our payables were also distorted by the impact of a stronger U.S. dollar. On a currency neutral basis payables were up $459 million from the prior year.

In the second quarter we repurchased $2 billion or approximately 16.1 million shares of outstanding stock. This included 4.1 million shares repurchased in the open market and 12 million shares repurchased through an accelerated share repurchase or ASR program.

For the shares repurchased under the second-quarter ASR program this is an initial calculation. The final number of shares repurchased will be determined upon the completion of the ASR in the third quarter.

Now you may recall we planned to repurchased $4.5 billion of our outstanding shares in fiscal 2015 using excess cash. In the second quarter we raised $2.5 billion of incremental long-term debt and will use the proceeds from that debt offering to increase our share repurchases to $7 billion for the year of which $3.9 billion will occur in the back half of the year.

Computed on the average of beginning and ending long-term debt and equity for the trailing four quarters, return on invested capital was 24.9%, 300 basis points higher than the second quarter of fiscal 2014.

One more comment on capital allocation. As you know we signed an agreement to purchase Interline and expect the closing to occur in the third quarter. We expect to fund the acquisition immediately with cash on hand but do plan to tap the long-term debt markets in the fall and raise incremental indebtedness in support of this acquisition. As a result and after giving consideration to the long-term debt we raised in the second quarter our adjusted debt to EBITDAR ratio will be slightly over two times.

Now moving to our guidance, we continue to see positive signs in the housing market. Home prices continue to appreciate and housing turnover and household formation are now slightly ahead of the assumptions we used to build our plan. While strength in the U.S. dollar continues to be a headwind our reported sales in the second quarter were better than our sales plan.

Our earnings per share were also stronger than our plan for the second quarter. Further, the acquisition of Interline will add sales and earnings that were not included in our previous guidance. As a result we are raising our sales and earnings per share growth guidance.

We now expect our fiscal 2015 sales to grow by approximately 6% with comps of approximately 4.9%. If the U.S. dollar remains at current foreign exchange rates, we would expect our fiscal 2015 sales growth rate to be 5.2% and comps to be approximately 4.1%.

Based on our year-to-date performance which includes breach-related costs that have been incurred this year and including the impact of the Interline acquisition, we now expect our fiscal 2015 expenses to grow approximately 48% of our sales growth rate. Excluding breach-related costs we expect our fiscal 2015 expenses to grow at approximately 39% of our sales growth rate.

For earnings per share remember that we guide off of GAAP. We now expect fiscal 2015 diluted earnings per share to grow by approximately 13.8% to $5.36 but if exchange rates remain where they are today our projected fiscal 2015 diluted earnings per share would be approximately $5.31.

Our updated earnings-per-share guidance includes our out-performance for the second quarter and about a penny of earnings per share attributable to the Interline acquisition. Our earnings-per-share guidance also includes the impact of the new capital allocation items I previously mentioned.

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

QUESTION AND ANSWER

Operator

(Operator Instructions) Seth Sigman, Credit Suisse.

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

Great, thanks for a much. Congrats, guys, on a great quarter.

I was wondering if you could elaborate on how Interline addresses the needs of the pro as you alluded to in your commentary? And I guess in general how will that tie-in and support the existing pro initiatives that you have in place such as delivery and credit extension? And then I realize it's early and the deal hasn't enclosed yet but if you could maybe just walk through the integration plans and where you see some of the opportunities?

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

So from a strategic standpoint we think about Interline and the capability to really take an end-to-end approach with our customers. In today's environment we have the ability in many of these spaces to handle the remodel portion of the business but don't do as well on the maintenance and repair portion.

If you think about Interline they actually do that side and don't have the capability to do the remodel. So we can take an end-to-end look at how we service the customers and grow our share of wallet with them overall. So we're excited about the opportunity that we have to not only grow with our current customers by giving them this new capability but also with the customers, the new customers that Interline brings to the business.

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

Okay, and I guess from a financial perspective embedded in the guidance is some small accretion from the deal. But how should we be thinking about some of the financial parameters around the opportunity here related to this over the next year or so?

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

Perhaps I can give you a little bit more color about the guidance that we prepared. Included in our growth guidance for the year is about $750 million of sales related to Interline in the back half of the year and about a penny of EPS accretion. But that penny is after the financing cost because we are going to tap the long-term debt markets and raise financing in support of the deal. So the operating profit for the back half of the year is around $50 million and when you add the interest expense and after-tax it's about a penny.

Looking ahead we would expect synergies coming off of this deal in a couple of different fashions. First, as Craig mentioned it's the ability to get more sales. We are both selling the customer and we are not satisfying that customer's needs completely so with an end-to-end process we believe we'll get more sales. That's the first synergy.

The second synergy is on the cost of sales. We had 42% overlap with our supplier base. We think there's margin accretion just by leveraging our common supplier base.

And clearly there is SG&A opportunities as well. So we didn't buy the deal for the synergies, however, it's really about the opportunity to serve a customer that we are currently serving today but not serving completely.

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

Okay, great. Thanks very much.

Operator

Michael Lasser, UBS.

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

Good morning, thanks a lot for taking my question. A couple of different things.

First, the industry growth was quite a bit slower in the second quarter than where it had been trending. Can you give some perspective on what do you think the flavor of that growth was? Was it just due to some of the weather that impacted maybe the nurseries in certain parts of the country and what precipitated the share gain for Home Depot during the time?

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

In the industry again I think depending on if you're looking at census data or some of the callouts from folks that have reported I think there is certainly some impacts in certain categories from what happened with weather as it relates as Ted called out the drought in California, certainly hurt categories like live goods and mulch and then heavy rains clearly in parts of the country as well.

In large part we obviously were able to offset that. And that came through strength across the store and continued strength in balance in our business with our DIY as well as a pro customers as well as our services business.

And share gains are something that we've been focused on for a number of years now. And it's all about staying focused on the value proposition that we give to our customers and understanding their needs. So I think we were able to take share across many categories in the store.

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

And Craig, on the flow throughout the quarter do you see some of the sales that were lost early in the period fall into the later period given the monthly breakdown? Or was it different categories that contributed later in the period such as air conditioning given the heat?

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

So air conditioning is a great point. We did see a more normal summer from an air standpoint in comparison to a year ago.

If you look at outdoor garden for us which was negative in this quarter on the half we had a positive comp. So it's the bathtub effect that usually happens with spring, you never know when it's going to break in what parts of the country. But pleased with the half performance on that overall.

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

And then let me just add one last question on the acquisition activity during the period. Do you look at this as kind of a one-time deal or do you look at it as a platform to build those capabilities even further into the maintenance and repair market and perhaps even other areas of the industrial supply sector given some of the history that the Company has with that sector?

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

We don't have any intent at this point to continue to acquire more capability. We believe with the acquisition that we've made that we've actually acquired the capabilities that we want to have and we'll now focus on how we serve our customers in both sides of the organizations and grow them.

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

Thank you so much.

Operator

Kate McShane, Citi Research.

Kate McShane - ***Citi Research - Analyst***

Thank you, good morning. My question is on the direct fulfillment centers. Now that you've opened your third one and are reaching a majority of your customers with two-day delivery do you think you need anymore and how much more efficient can those centers get over time?

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

Well, obviously we're just in the stages of opening our third one and receiving product into that building. So it's a very, very early days but Mark Holifield is here. I will let him comment.

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

As Craig mentioned the third one is in the process of stocking. We think that three will do us fine for the stated goal of getting the customers on two-day parcel delivery. The thing to keep in mind about The Home Depot is in addition to the three Direct Fulfillment Centers we have 2,000 stores that are conveniently located and we're working delivery capability from the stores.

So we look at the stores to really be the expedited capability to put product in the hands of customers. We think that these three will do us fine as we look to get the second-day delivery of parcels.

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

And Kate if I could just jump in on the financial side, as you heard we had great productivity in our supply chain in the second quarter. We did in the first quarter as well.

As we look to the back half of the year we wouldn't expect to see that kind of productivity. Because as we go into the back half of the year we have a higher penetration of imported products and international shipping comes at a higher cost. So while we're going to drive productivity don't expect to see the kinds of gains that you've seen recently.

Operator

Aram Rubinson, Wolfe Research.

Chris Bottiglieri - ***Wolfe Research - Analyst***

This is actually Chris Bottiglieri on for Aram. I was wondering if you could talk about conditions out West with the drought, that has occurred for a few years now.

Just wondering if you're seeing any shift in consumer behavior? Are people throwing more money at the problem into adjacent categories as they try and tackle the drought or is it shifting into unrelated categories?

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

Well, what we're doing in the live good category specific we've definitely shifted the assortment into water tolerant or drought tolerant species so a lot more cactus and succulents. We're also diminishing the size of live goods in a number of stores and expanding pavers and the like as we see people definitely taking grass, diminishing the size of their lawn and putting in more pavers and succulents.

Chris Bottiglieri - ***Wolfe Research - Analyst***

Okay, and then how about related I guess just general severe rainfall and weather, how does that usually impact the consumer behavior? Is that just you lose those sales are do you see people prioritize other projects?

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

I don't think we see a loss in sales but certainly as Craig said in timing and the bathtub effect, if you take the rain that we had in Texas and the Midwest for example in the earlier part of the spring certainly sales suffered. And that's part of the pickup you see in our comp in July, the rain finally stopped and all the grass and weeds started to grow. So we had a very strong July in those markets with outdoor garden and indoor garden.

Chris Bottiglieri - ***Wolfe Research - Analyst***

Okay cool. And not to hit weather too hard but just one last one. As you anticipate El Nino coming around this time of year it looks like it's going to be pretty severe. Anything you're doing to prepare for it based on past experiences with it?

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

That's something that we do on an ongoing basis. We have plans that we put together if you will and anticipation of events. We're actually pretty good at this and so we're prepared for any adjustments we need to make as a result of that.

Chris Bottiglieri - *Wolfe Research - Analyst*

Okay great. Thanks for the help.

Operator

Christopher Horvers, JPMorgan.

Christopher Horvers - *JPMorgan - Analyst*

-- on the seasonal shift, can you talk about what the core business say ex-outdoor seasonal comp in the second quarter and compare that to what that level was in the first quarter?

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

We couldn't hear you when you began your question.

Christopher Horvers - *JPMorgan - Analyst*

So trying to figure out what the underlying growth in the core business ex- the seasonal shift is in the second quarter relative to what you saw in the first quarter.

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

I think the performance of the core of the store as we call it is similar. It remains very, very strong. Our hardware business, our plumbing business, appliance business, flooring business, the categories that have been strong continue strong.

Our hard set for example in flooring, tile and tile set and wood and laminate remains very strong. Our power tools and power tool accessories and hand tools remain very strong. Plumbing, water heaters, pipe and fitting, etc., so that core DIY product and pro heavy product the rate of sale has continued strong into Q2.

Christopher Horvers - *JPMorgan - Analyst*

Okay, understood. Then on the SG&A expense growth rate versus the sales growth rate Carol it looks like it picks up in the back half of the year.

Is something changing? Does any of it have to do with the timing of bonus accruals and perhaps wage pressures in the business?

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

It does kick up in the back half there for a couple of reasons. First, we have the Interline acquisition in our guidance and Interline has a different cost structure than our core retail business. Also we have some expense good guys that will not repeat themselves in the back, particular in relation to some casualty reserve adjustments that were taken last year that we don't think will repeat this year.

Christopher Horvers - ***JPMorgan - Analyst***

Okay. And then last question is given the early good spring sales and then this shortened season in the second quarter, did you change your planned promotional posture during the quarter, and what did you see out in the market? Thanks.

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

We really didn't change any promotional cadence on our part. And Ted I don't know --

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

I don't think it was any more or less promotional than prior years.

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

And really don't see a ton of change in the marketplace.

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

No.

Christopher Horvers - ***JPMorgan - Analyst***

Thanks very much.

Operator

Brian Nagel, Oppenheimer.

Brian Nagel - ***Oppenheimer & Co. - Analyst***

Hi, good morning. Nice quarter.

A question on the pro and I know some other questions already addressed the pro, but as I look at it and as a listen to the call today and maybe a couple of your past calls it seems to me Home Depot is putting a bigger and bigger emphasis on attacking this pro customer with maybe more directed merchandise numbers and such. As you're doing this and with the Interline or some of the merchandise numbers are you seeing an almost immediate pickup in that pro business, in other words is the pro sales inflicting higher?

And that's the first question. The second question, as you look further down the road how big do you think now the pro opportunity is for Home Depot?

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

Well let me as it relates to the reaction if you will of the pro we have been focused on the pro as you know for quite some time. It's a very important customer base of ours but we do believe that we have a fair amount of opportunity to expand our share of wallet penetration with this customer.

We have obviously not completed the acquisition so we haven't seen any benefit as a result of our intended acquisition of Interline but believe it's an opportunity for us to expand the share of wallet. As Ted detailed we're very pleased with the performance that we're seeing in pro categories. And that's I think a reflection of the continued rebound in the economy, the continued rebound in home values where customers are more willing today to invest in their home than what they were obviously during the economic downturn.

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

And if we look at our managed accounts and those pro customers who tender are using our private label credit card, those two groups of pro customers make up about 20% of our sales. We saw that their growth rate was higher than the Company average.

So to your question are you seeing a bang for your buck? Well yes, we see sales performance that is outperforming the Company average.

Brian Nagel - ***Oppenheimer & Co. - Analyst***

Got it. Then just a follow-up separately, Carol any comment I know it's early in the third quarter but any comment on sales the sales quarter to date?

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

Yes, happy to comment on the quarter today performance. We're very pleased.

Brian Nagel - ***Oppenheimer & Co. - Analyst***

I appreciate that. Thank you.

Operator

Seth Basham, Wedbush Securities.

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

Good morning. My first question is around big-ticket, it seemed like you had pretty good big-ticket performance this quarter. I was wondering whether you could attribute to anything specifically that you guys did or more of a macro trend?

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

I would say yes we talked a lot about the pro but the consumer business performed very well in Q2 and really was the driver of our ticket performance. So appliances was very strong again and that was driven by our Red, White and Blue event around the Fourth of July. The stores really get behind us and drive the business and I think that's a distinction for Home Depot.

Our kitchen and countertop business likewise was very strong in the quarter. I mentioned flooring. We've seen strong sales across the flooring category but particularly in hard surface.

And then we even saw things like special order window coverings as we leveraged the blinds.com acquisition, we're seeing nice sales out of blinds.com platform and work they've done for our business in The Home Depot is driving the business. And then the riding mower business and walks and all outdoor power performed very well.

And we have a lot of new programs like the new Cub Cadet tractor that's performing very well for us this year and our lineup of all the top brands in walks. So very strong consumer and I think in each of those examples are things where The Home Depot is driving the business.

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

We get a little bit from the economy too. Home price appreciation continues to progress nicely. Prices are up 4% and as we've talked about when the consumers believe their home is an investment and not an expense they spend differently and we're seeing that spend pattern.

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

That's helpful. As you look at the outlook form a macro standpoint with a good likelihood of rising interest rates, do you think that might quell some of the demand for big-ticket items going forward over the next year?

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

I think when you look at historical trends we've been so far below the market that at this point we don't think we'll see a major impact to the business.

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

Got it, thank you and good luck.

Operator

Matthew Fassler, Goldman Sachs.

Matthew Fassler - ***Goldman Sachs - Analyst***

Thanks a lot. Good morning. My first question relates to same-store sales.

So last quarter you gave us some fairly fine tune commentary about the relationship of the two halves from a sales perspective. And in particular triangulating what you've been saying for the past several quarters it sounded like you originally expected the second quarter to be the softest same-store sales quarter of the year.

So given that you outperformed your plan for Q2 do you continue to expect that to mark the low end of the comp range for the year? Or is there a new cadence that you have in mind?

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

If we look at the high-end of guidance which is basically currency neutral for Q3 and Q4 we would still expect the second quarter to be the lowest comping quarter because it had the FX impact in it. So there's not a lot of difference, Matt, between the first and second half again using that high-end of our guidance. We would expect the second half to be slightly under the first half but not materially different.

Matthew Fassler - ***Goldman Sachs - Analyst***

Got it. And then just as a quick follow-up Carol you talked about the leverage ratio going above two times to get the Interline deal funded.

As you think about going forward into 2016 and beyond just theoretically are you comfortable living at that level of leverage i.e., maintaining it and continuing to buy back stock and fund it as you have? Or you would you want to work that back down below two times as the cash flow continues to come in?

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

As we continue to earn more that ratio will naturally decline and it's not our intent to let it decline. Keeping it at around the two times is our intent.

Matthew Fassler - ***Goldman Sachs - Analyst***

Got it. Thank you so much.

Operator

Jessica Mace, Nomura Securities.

Jessica Mace - ***Nomura Securities - Analyst***

Hi, good morning. In an earlier question you talked a little bit about your performance versus the overall market and I was wondering if you could mention maybe any competitive dynamics that there might be to call out any categories where you're seeing big opportunities or maybe the competitive environment is intensifying?

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

I think as I referenced earlier we're not seeing a major shift in competitive environment in total. I can tell you paint is a pretty competitive market, it is probably as competitive as it has been.

It seems like a lot of folks are focusing there. But overall I wouldn't say that we're seeing big changes in the competitive environment.

Jessica Mace - ***Nomura Securities - Analyst***

All right, thanks. And then your strong performance in big-ticket as you said earlier, anything on the 1.7% growth in average ticket, anything to call out other than FX and deflation to keep in mind about different dynamics going on there?

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

No, you've got it.

Jessica Mace - ***Nomura Securities - Analyst***

All right, thanks so much for taking the questions.

Operator

Scot Ciccarelli, RBC Capital Markets.

Scot Ciccarelli - ***RBC Capital Markets - Analyst***

Hey guys. I guess my first question is I know you guys have been running some tests on the pro side with credit extension and let's call it tighter delivery windows of the new system. Is there any way to provide some color regarding what you guys are currently seeing and when might we hear whether this is a full rollout on these two programs?

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

I can start on the credit side. We've been a pilot now for a while, we're in a pilot about 262 stores. We really like the results.

We're optimizing our sales performance and our expense performance. We really like the results. But as you know we had a data breach last year that we needed to get through.

We're rolling out EMV this year, so we've just got a lot of changes going on in terms of the front-end of our store and accepting credit. So that puts it to roll that out on hold until we get through really EMV and EMV deadline as you know is October 1. So stay tuned for more to come in that regard, and Mark maybe you want to talk about delivery.

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

Sure. We're in four markets with our Buy Online, Deliver from Store implementation. Something to keep in mind is virtually all of our stores are in the delivery business, it is just that we're now enabling the buy online line component of that. And as part of that we're enabling tighter delivery windows.

So we're in four markets now. We're working to really perfect that and make that a flawless customer experience.

I would say that tighter time windows are harder to meet than all day windows. So we want to be absolutely certain that we can meet those before we roll further. But we would expect to roll that through 2016.

Scot Ciccarelli - ***RBC Capital Markets - Analyst***

Well, I know you guys have obviously you're testing a lot of different things, as Brian mentioned before you guys have continued to add brands, you've just bought Interline. Are there any big holes in your capabilities now with serving the pro? It sounds like you're not necessarily going out to acquire anything but can you identify anywhere where you feel like you really need to improve on the pro or do you think you have that blanketed at this stage?

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

I think a number of these things that we're working on as you've heard around the credit, around delivery and continuing to narrow the windows, the ability with the acquisition to have a dedicated sales force that can hit to the jobsite and candidly the organizational change that we made with Bill are important pieces to allow us to begin to drive change and improvement in the share of wallet with our customer base and to expand our customer base. So we feel like we are working towards all the right capabilities that we need to have and look forward to getting them all in place across the organization and then really looking to leverage that and provide a better experience for our pro customers.

Scot Ciccarelli - ***RBC Capital Markets - Analyst***

Excellent, thanks a lot, guys.

Operator

Keith Hughes, SunTrust.

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

Thank you and yet another Interline pro customer question. If you look several years down the road with Interline will you try to integrate the service function, the delivery function that is so important at least in the MRO piece of the business with what you just described with more of the deliveries coming out of the orange box stores?

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

I think you could probably assume that will be part of the plan as we go forward.

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

And would you take that and then bolt-on to other pro submarkets beyond the reach of Interline currently?

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

I doubt it.

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

The addressable market is $50 billion. Between The Home Depot and Interline we have less than 5% market share. Just growing in that addressable market of a customer we already serve is a lot of growth opportunity for us.

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

Second question, final question, you had called out flooring as an above the comp, talked about hard surface growing. You appear to be doing a lot better than the industry at this point. Is there any one specific promotion that's working a product, just any sort of detail there would be helpful.

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

I think we continue to bring newness and innovation into that space both in terms of the product as well as the way we go to market in the store. We have a number of different sets and configurations in our stores where we're emphasizing based on clustering where we're emphasizing hard surface versus soft surface and then the new Lifeproof carpet that we just launched we're very excited about that, that stain resistant guarantee.

We're seeing very strong early results with the Lifeproof. So it's all about innovation and go to market in the stores.

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

I would say that it's leveraging the capabilities that we've built over the last few years in terms of our assortment planning capabilities and really clustering to get it right.

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

Thank you.

Operator

Simeon Gutman, Morgan Stanley.

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

Thanks a nice quarter as usual. A question about the shape of the housing recovery. I'm not sure if it was my words or yours but we've been characterizing it as mid-cycle and you've been telling a story of a pretty balanced comp from a category perspective. But can you discuss anything you're seeing geographically by market that can inform the shape of the recovery whether maybe it is earlier than mid-cycle or even later in some markets based on what you're seeing projects being done?

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

Well we're seeking to understand that as well. We looked at the comp variability by region and we have 19 regions in the United States. And interestingly if you look at the high to low there's a 6.5 percentage point difference. That's exactly what it was a year ago.

So we're not seeing any regional differences that really help us inform the shape of the housing recovery. So then we go back to the overall macro and here's where we see that home price appreciation is continuing, home prices are up 4%, they have not fully recovered.

Housing turnover is higher than what we had anticipated at the beginning of the year. We see some interesting dynamics happening with household formation and in fact 1.6 million households were formed in the second quarter. This is something that we have been hoping for.

Now not all of those households are going into single family units, they are going into rental units but that's okay because we can serve those rental units.

It's really interesting to note that of the 135 million housing units in the United States 44 million of those are rental units and of those 13 million are single family homes. So we can sell that customer and now we can sell with the acquisition soon to be completed of Interline, we can sell the MRO customer in ways that we've never sold before.

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

You know, in comparison if you think back during the difficult times of the economic downturn the variability by market was significant in comparison to what Carol just described where basically the spread is the same as what it was a year ago. So it's for sure stable.

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

And household formation data, that doesn't come out regionally. Do you have a sense that to see how that shapes up by geography?

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

We don't. We're trying to get behind the covers but we don't have that today.

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

Okay. And my follow-up, question on wage inflation and this is applies to HD but maybe also a bigger generic question for the industry. Because I think the conversation is evolving a little bit where initially it was about just rising minimum wages and now we're starting to hear retailers talk about wage creep across their cost structures. And so I'm curious how I guess curious how you think of that is that fair and how Home Depot is planning to deal with it?

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

We look at wage obviously on a market-by-market basis. We are constantly and have been for years adjudging based on the market dynamics. We've made thousands and thousands of adjustments this year as we would in previous years.

We pride ourselves on trying to make sure that we have a compensation overall that is above market. And that's something that we will continue to focus to do. But clearly there's markets where we've had to make adjustments and we've done so.

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

Okay, thanks.

Operator

Dan Binder, Jefferies.

Dolph Warburton - ***Jefferies & Co. - Analyst***

Hi, this is Dolph Warburton on for Dan. Can you talk a little bit about your ad spend for the year and how this will look versus last year as well as the mix of digital versus print?

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

So our ad spend is pretty flat year over year. And we have been for numerous years now in an effort to shift our spend to new mediums and platforms.

As an example if you step back several years ago we had on average over 50 print pieces that hit the street in a year. I think this year we will do something like 11. So we've made a pretty hard shift to new platforms in the digital space.

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

That allows us actually to have more impressions than we had year on year just by the way we've changed the mix.

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

And more targeted messages if you will, based on what the customer is looking for. So we're actually very pleased with the productivity of our ad spend and what our marketing team is doing to reach the customer and provide information around what it is the customer is looking for.

Dolph Warburton - ***Jefferies & Co. - Analyst***

Great, thanks. And if I could ask one last question on the piloting of the auto supply products how that's going? Thank you.

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

We're pleased with that. Ted, if you want to comment --

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

Yes, so we're for a pleased with that. We have a one or two base set in all stores and then in 500 odd stores at the end of the second quarter we had an extended set of up to six Bays.

And we're looking at the different locations in the store. If the category is more productive in the front ends or in Bay, so we have various tests going on with those six Bay sets and very pleased again this is very much a DIY auto, it's a traffic driver and a convenience for our customer.

Dolph Warburton - ***Jefferies & Co. - Analyst***

Great, thank you.

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

Derek, we have time for one more question.

Operator

David Schick, Stifel.

David Schick - ***Stifel Nicolaus - Analyst***

Hey, look at that. Thank you.

So home automation, you mentioned in some of the products, even in pro enabled products around home automation, you see it when you land on your page online. We see it in the stores as we walk the stores.

Obviously you're talking about hard flooring which is not a home automation product yet. But talk about home automation and how it's driving the business at all with new customers. Or any color you can give around home automation and if it's how it's changing your view to driving the business.

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

Well, I would start with our key focus around home automation is around product. And it starts with making sure that we're giving the customer a choice around product that is enabled. And Ted I don't know if you want to provide any specifics.

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

Yes, I mean we have hundreds of products now that are in some sense interconnected or smart enabled. We're very happy with our Wink platform which is an agnostic platform in that any and all products can link into the Wink system.

And I would say that we're focused on functionality versus gimmickry. So the use cases are maturing for the customer and we're seeing products fulfilling use cases, so say in a water heater where if you're away on vacation and you forgot to turn down the water heater from your phone you can turn down the temperature, you can obviously dim lights.

I mentioned the LED light that we're able to change the color temperature of the light. So we're actually starting to see nice features that benefit real-life use cases and we're investing in that product across the store and seeing great lifts in all categories we introduce relevant smart products.

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

The other comment would be you will continue to see products over the next several years I think be integrated into more and more technology. So I think this is an opportunity as we go forward.

David Schick - ***Stifel Nicolaus - Analyst***

And do you think that's a different new customer or its your same customer is discovering these capabilities?

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

Same customers finding this new product to be very convenient.

David Schick - ***Stifel Nicolaus - Analyst***

Thank you.

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

Well thank you all for joining us today. We look forward to joining you next quarter.

Operator

That does conclude today's conference. Thank you for your participation.