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Q1 2023 Earnings Call

Company Participants

- Hector A. Padilla, Executive Vice President - Outside Sales and Service
- Isabel Janci, Vice President of Investor Relations and Treasurer Senior Director of Corporate Communications
- Jeff Kinnaird, Executive Vice President - Merchandising
- Richard Mcphail, Chief Financial Officer & Executive Vice President
- Ted Decker, Chief Executive Officer & President

Other Participants

- Chris Horvers, Analyst
- Chuck Grom, Analyst
- Karen Short, Analyst
- Michael Baker, Analyst
- Michael Lasser, Analyst
- Scot Ciccarelli, Analyst
- Simeon Gutman, Analyst
- Steven Zaccone, Analyst
- Zachary Fadem, Analyst

Presentation

Operator

Greetings, and welcome to The Home Depot First Quarter 2022 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 {BIO 16473072 <GO>}

Thank you, Christine and good morning, everyone. Welcome to Home Depot's first quarter 2022 earnings call. Joining us on our call today are Ted Decker, CEO and President; Jeff Kinnaird, Executive Vice President of Merchandising; and Richard McPhail, Executive Vice President and Chief Financial Officer.

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

Before I turn the call over to Ted, let me remind you that today's press release and the presentations made by our executive 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 press release and in our filings with the Securities and Exchange Commission. Today's presentation will also include certain non-GAAP measures. Reconciliation of these measures is provided on our website.

Now, let me turn the call over to Ted.

Ted Decker {BIO 16614891 <GO>}

Thank you, Isabel, and good morning, everyone. We appreciate you joining us on the call this morning. Fiscal 2022 is off to a strong start. Sales for the first quarter were $38.9 billion, up 3.8% from the same period last year. Comp sales were up 2.2% from the same period last year, and our US stores had positive comps of 1.7%. Diluted earnings per share were $4.09 in the first quarter, up 6% from $3.86 in the first quarter last year.

The strong performance in the quarter is even more impressive, given the robust performance we were comparing against last year. A year ago, we delivered the highest first quarter sales in company history as we benefited from outsized demand for home improvement goods, favorable weather and government stimulus. This year, we achieved a new high watermark for first quarter sales as strong demand for home improvement goods continued, despite a slower start to spring in many parts of the country.

Delivering such strong results on top of last year's historical growth is a testament to our orange-blooded associates. They are maintaining their relentless focus on our customers, while continuing to navigate the ongoing pandemic, global supply chain disruptions, inflation and a tight labor market. We are also thankful for the strength of our relationships with our supplier and transportation partners. Our respective teams are working tirelessly to flow product to source and distribution centers as quickly and efficiently as possible. I would like to thank them for their ongoing support, as we continue to navigate a challenging and dynamic environment.

The demand seen in the first quarter exceeded our expectations. The home improvement consumer remains engaged. Customers continue to tell us that their homes have never been more important, and project backlogs are very healthy. We believe that the medium to longer-term underpinnings of demand for home improvement have never been stronger. We are thrilled with our Pro performance in the quarter, driven by underlying strength in project demand. We continue to invest in an ecosystem of capabilities, including enhanced fulfillment options, a more personalized online experience, as well as

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other business management tools to drive deeper engagement with our Pro customers. And we believe our efforts are resonating.

We are navigating a unique environment, but we believe we have the tools, the team and the experience to effectively manage through. While we don't know how inflation might impact consumer behavior going forward, we are closely monitoring elasticities and customer trends across our respective categories and geographies and remain encouraged by the underlying strength we see in the business. Jeff will provide a bit more color about what we've observed from a category and big ticket standpoint in a moment.

And while inflation impacted our average ticket increase this quarter, it wasn't the only impact. As we've seen over the past several years, our customers continue to trade up for premium innovative products. In March, we held an in-person store manager meeting for the first time in three years. One of the many highlights of that week is our Product Walk, where vendors showcased the latest in product innovation. And what I can share with you is that the level of innovation across the business is robust. In fact, almost 90% of the products on display this year are entirely new SKUs to The Home Depot. So the pipeline for innovative products remains very strong. Beyond product and innovation, my biggest takeaway from the store managers meeting is how energized the team is. The exceptional execution our associates delivered over the last few years hasn't been easy, but our teams have consistently risen to the challenge. We frequently survey our associate base and are pleased that engagement and morale remain high.

Last quarter, we talked about our customer-backed approach to remove friction at every touch point of the shopping experience. To that end, we recently announced that Matt Carey has been named Executive Vice President of Customer Experience. In this newly formed role, Matt will partner across the business to help design and develop new and innovative solutions to drive a seamless experience for our customers.

As Matt transitions to this new role, we also announced that Fahim Siddiqui has been promoted to Executive Vice President and Chief Information Officer, where he is responsible for all aspects of our technology development and strategy. These moves will help drive further alignment around our interconnected retail strategy, which will allow us to enhance what we believe is the best experience in home improvement.

Richard will talk to you in a few minutes about our guidance for the remainder of the year, but the first quarter certainly got us off to a great start. We're also encouraged by the continued strength we see in the business through the first two weeks of the second quarter as spring is breaking more broadly across the US. Our team continues to focus on what is most important; our associates and customers. Our merchants, store and met teams, supplier partners and supply chain teams did an outstanding job delivering value and service to our customers throughout the quarter. I'd like to close by thanking them for their dedication and hard work.

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

Jeff Kinnaird {BIO 19649706 <GO>}

Thank you, Ted, and good morning, everyone. I want to start by also thanking all of our associates and supplier partners for their ongoing commitment to serving our customers and communities. As you heard from Ted, during the first quarter, we continued to see outsized demand for home improvement projects and strong execution from our teams and supplier partners.

Turning to our comp performance during the first quarter, 11 of our 14 merchandising departments posted positive comps, led by plumbing, building materials, millwork and paint. During the first quarter of this year, we saw double-digit negative comps in our seasonal departments due to the late arrival of spring. Appliances posted slightly negative comps. Adjusting for a shift in event timing, appliance comps would have been positive for the quarter. Excluding seasonal categories, we are thrilled with the broad-based strength across the business and healthy project demand.

During the first quarter, our comp average ticket increased 11.2% and comp transactions decreased 8.4%. The growth in our comp average ticket was driven primarily by inflation across several product categories as well as demand for new and innovative products. Comp transactions reflect the late start to spring and anniversarying of stimulus. And on a two year and three year basis, both comp average ticket and comp transactions were healthy and positive.

Inflation from core commodity categories positively impacted our average ticket growth by approximately 240 basis points during the first quarter, driven by inflation in lumber, copper and billing materials. Lumber prices remained volatile during the quarter. As an example, framing lumber peaked at approximately $1,300 per 1,000 board feet during the first quarter, before falling over $400 to approximately $900. Big ticket comp transactions or those over $1,000 were up 12.4%, compared to the first quarter of last year. We saw big-ticket strength across many Pro-heavy categories like pipe and fittings, gypsum and fasteners.

During the first quarter, Pro sales growth outpaced DIY. On a three year comp basis, both growth with our -- growth with both our Pro and DIY customers was consistent and strong. We're encouraged by the momentum we are seeing with our Pros, and they tell us that their backlogs are strong. And during the quarter, we saw many of our customers turn to Pros to help them with larger renovation projects. This can be seen in the double-digit comp performance of our building materials and flowing departments, as well as in certain kitchen and bath categories like in-stock kitchens, tubs and showers and countertops. We also saw double-digit growth in our kitchen and bath installation business. This underscores the strength of project demand we are seeing across the business.

Sales leveraging our digital platforms increased 3.7% during the first quarter. We are very pleased with the performance of our digital assets as we delivered the highest sales dollar volume in our company history. For those customers that chose to transact with us online during the first quarter, more than 50% of our online orders were fulfilled through our stores, a testament to the power of our interconnected retail strategy.

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As you heard from Ted, we are very excited about the innovation we are introducing across the business. We continue to lean into products that simplify the project, saving our customers time and helping them take on more jobs. One example is our Viega ProPress line of plumbing. Your plumbers can create a water-tight copper connection in 60% less time than a traditional copper solder job. Viega ProPress fittings require no flame and work in wet applications. Viega is the market leader in this space and is exclusive to The Home Depot in the big-box channel.

In paint, working with Masco and PPG, we have put together a formidable Pro paint lineup that is resonating with our Pro painters. Masco's bare-formulated, Pro-specific offering continues to perform well in our stores. And in the first quarter, we added PPG Speed High series. This Pro-specific paint that is specced in the vast majority of multi-housing and large commercial jobs, giving us an entry point with our Pro painter for larger-scale projects. And this is now exclusive to The Home Depot in the big-box channel.

In spray paint, we launched PPG's GlitonMaxFlex spray paint. PPG's proprietary industrial-based technology is uniquely flexible, covering and preserving their original look and feel of a wide range of services, including leather and fabric. And with Masco, we've expanded their exclusive offerings to spray paint, Cox and sealants as well as interior stains.

Now let's turn our attention to spring and the exciting lineup of products we have for our customers. We are thrilled to showcase our new product offerings across our seasonal categories. We are seeing an industry-wide shift from gas-powered to battery-powered mowers. Demand for cordless mowers have never been stronger. And our lineup of battery-powered mowers, including RYOBI's 80-volt zero-turn riding mower, Milwaukee's new MAT fuel walk mower, DEWALT's FlexVolt walk mower and Makita's LXT walk mower is unmatched. This lineup offers something for everyone, building on an ecosystem of innovative tools powered by the same battery platforms.

In patio, we have continued to add optionality. And today, customers can create their perfect patio set to transform their outdoor living space through an enhanced online experience. And we expanded our assortment of grills. We're particularly excited about our new Traeger Timberline XL, which provides a larger cooking surface, easier maintenance and a side burner to enhance your cooking needs. Our new Nivo Next Grill is the first propane-powered grill controlled via an app or your mobile device. The app displays timers, grill temperatures and internal food temperatures, providing a consistent cooking experience for hours.

We're also excited about our Live Goods program. Each year, our merchant provider customers with new and improved varieties to enhance the overall garden experience. We've expanded our disease and drought resistant products offering superior performance. For example, beacon impatiens are disease-resistant, and our easy wave petunias now require less sunlight and lasts up to six weeks longer. Adding these new hardier plants allows our customers to have a vibrant and healthier garden for longer. Our Live Good category looks incredible. We are ready for spring from everything from shrubs to a variety of flower and edibles for every type of gardener.

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And with that, I'll turn the call over to Richard.

Richard Mcphail {BIO 19175260 <GO>}

Thank you, Jeff and good morning, everyone. In the first quarter, total sales were $38.9 billion, an increase of $1.4 billion or 3.8% from last year. During the first quarter, our total company comps were positive 2.2%, with positive comps of 12.9% in February, essentially flat in March and negative 2% in April.

Comps in the US were positive 1.7% for the quarter, with positive comps of 12.5% in February, negative 0.3% in March and negative 2.9% in April. Recall that March reflects the anniversarying of stimulus and April was impacted by a delayed spring this year.

Our results this quarter were once again driven by continued strength across the business. Spring temperatures broke late in all our geographies, but in particular impacted some of our Northern regions. In local currency, both Mexico and Canada posted comps above the company average. In the first quarter, our gross margin was 33.8%, a decrease of approximately 20 basis points from last year, primarily driven by supply chain investments and pressure from lumber.

We continue to successfully offset significant transportation and product cost pressures, while maintaining our position as the customers' advocate for value. During the first quarter, operating expense as a percent of sales remained essentially flat last year at approximately 18.6%. We were pleased with our operating expense performance during the first quarter, which reflected planned increases in wage and planned rollout of investments designed to drive efficiency in our store environment.

Our operating margin for the first quarter was 15.2%, compared to 15.4% in the first quarter of 2021. Interest and other expense for the first quarter increased by $36 million to $369 million, due primarily to higher long-term debt levels than one year ago. Our effective tax rate was 23.9% in the first quarter of both fiscal 2022 and 2021.

Our diluted earnings per share for the first quarter were $4.09, an increase of 6% compared to the first quarter of 2021. Our total store count at the end of the quarter was 2,316 and selling square footage was 240 million square feet. Unfortunately, during the quarter, we lost a store in San Jose, California, due to a fire. Thankfully, no one was injured and all of our associates have been reassigned to other nearby stores and the team has done a fantastic job continuing to serve our customers in the area.

At the end of the quarter, inventories were $25.3 billion, up $6.1 billion, compared to the first quarter of 2021 and inventory turns were 4.4 times, down from 5.5 times last year. This level of inventory reflects outsized demand for home improvement projects, actions taken to improve in stocks and the impact of the delayed start to spring. While our in-stock position is not back to pre-pandemic levels, it is the healthiest, it has been since the pandemic began.

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Turning to capital allocation. After investing in our business and paying our dividend, it is our intent to return excess cash to shareholders in the form of share repurchases. As we have mentioned on previous calls, we plan to continue investing in our business with CapEx of approximately 2% of sales on an annual basis. We also plan to maintain flexibility to move faster or slower depending on the environment.

During the first quarter, we invested approximately $700 million back into our business in the form of capital expenditures. And during the quarter, we paid approximately $2 billion in dividends to our shareholders and we returned approximately $2.25 billion to shareholders in the form of share repurchases. Computed on the average of beginning and ending long-term debt and equity for the trailing 12 months, return on invested capital was approximately 45.3%, up from 45.1% in the first quarter of fiscal 2021.

Now, I'll comment on our updated guidance for fiscal 2022. As you heard from Ted, we are very pleased with the strong performance we saw during the first quarter, which surpassed our expectations. Today we are raising guidance for 2022. We now expect sales growth and comp sales growth of approximately 3% for fiscal 2022. We expect comps to be stronger in the first half of the year than the second half of the year.

We expect our fiscal 2022 operating margin to be approximately 15.4% for the year. And we expect mid-single-digit percentage growth in diluted earnings per share, compared to fiscal 2021. While a number of uncertainties remain, we feel confident that we will be able to continue to manage through a dynamic environment, while growing faster than our market in delivering exceptional shareholder value.

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

Questions And Answers

Operator

Thank you. We will now be conducting a question-and-answer session. (Operator Instructions) Our first question comes from the line of Michael Lasser with UBS. Please proceed with your question.

Q - Michael Lasser {BIO 7266130 <GO>}

Good morning. Thanks a lot for taking my question. Understanding that your overall results were very strong, are you seeing any signs that either inflationary pressure, rising interest rates or simply home improvement fatigue are starting to have a negative impact on the business? And does it give you pause that comp transactions were down high-single-digits in the quarter as maybe a leading indicator that the business could soften from here?

A - Ted Decker {BIO 16614891 <GO>}

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Thanks, Michael. Good morning. So a lot in that question. As we've said, we had a great Q1 in comp-to-comp from last year. As you recall, Q1 last year was our highest first quarter sales and our highest comp at 31% in the very, very long-time. So as we went into this year, we were understandably conservative as to how we thought Q1 would pan out.

But in fact, we saw that the consumer is very engaged. The Pro is very strong, and we posted those results with very much delayed spring. In Q2, it's early, but we're off to a strong start. We also think that the fundamentals, I mean, these are all very short-term in nature comments. But the fundamentals for home improvement remain incredibly supportive.

So when you look at inflation and interest rates in any fatigue, if I take those in order, inflation is definitely higher than we thought. If you recall, last year, we thought we'd have about 5% growth in ticket. We're seeing obviously much higher than that, with 11% in ticket. A lot of that is inflation-driven. But our customers are resilient. We are not seeing the sensitivity to that level of inflation that we would have initially expected.

On interest rates, and Richard can talk a little bit more about interest rates and housing, but we have not seen that impacting our business. And the nature of housing, again, Richard will cover in greater detail. And then the fatigue, we're not seeing at all. We'd look at PCE and ships in PCE, and while we are seeing some shift to services in general, we're not seeing a big shift out of home improvement, and we're not seeing fatigue with our customers, given repair/remodeler, intent and activity still tracking at the highest levels that we've recorded.

And then lastly, on transactions, we do always look for a balance of ticket and transactions. But again, with these inflation rates, it's a very unique year in inflation, and ticket is higher the norm for sure. But again, the consumer is hanging in there.

And Richard, why don't you touch on the interest rates?

A - Richard Mcphail {BIO 19175260 <GO>}

Sure. So just first to start with who our customer is, you need to keep in mind, our customers are homeowners. Virtually, all sales to our Pro customers are on behalf of a homeowner, and over 90% of our DIY customers are homeowners as well. So let's talk about home improvement demand and what drives it.

Over our history, we've seen that home price appreciation is the primary driver of home improvement demand. When your home appreciates in value, you view it as a smart investment and you spend more on it. So let's look at what's happened at home prices. We've seen appreciation of over 30% over the last two years. In fact, home equity values over the last two years have increased by 40% or over $7 billion just in the last two years.

So the homeowner has never had a balance sheet that looks like this. They've seen the price appreciation, and they have the means to spend. And in surveys, our customers tell us that their homes have never been more important, and their intent to do projects of all

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sizes has never been higher. And our Pros say the same thing about their backlogs. So let's talk about interest rates.

I think it's important to remember that our addressable market is the 130 million housing units occupied in the US, plus probably, call it, 40 million to 50 million more in Canada and Mexico. Of those 130 million housing units, on any given year, only about 4% or 5% are sold. That means, that over 95% of our customers are staying in place. They're not shopping for a mortgage. Nearly 40% of those homes are owned outright. Of those who have mortgages, about 93% of those mortgages are fixed rate.

So when you think about our addressable market, the vast majority aren't really paying attention to mortgage rates. And what we've -- what's interesting about that is, what we've heard, when they do look at moving, they're actually more and more tempted to stay in their low fixed rate mortgage and remodeled their home instead. So these low locked-in mortgages are probably a benefit to home improvement.

Q - Michael Lasser {BIO 7266130 <GO>}

That's all very helpful information. And in light of that, I hate to follow up with such a negative question. But out of an abundance of conservatism, I'll ask that. Historically, Home Depot has talked about a 20 basis point margin change for every 1% increase or potentially decrease in its same-store sales. Recognizing that the environment hasn't necessarily been business as usual for quite some time. If we do want to take a conservative expectation on the overall macro, would it be reasonable to think that, if comps were to decline 1% that, that would translate to a 20 basis point decline in operating margin? Or has the business just advanced so much over the last few years through the deployment of technology, a greater sophistication of supply chain and other factors that perhaps the deleverage wouldn't be as significant moving forward as it might have been in past?

A - Richard Mcphail {BIO 19175260 <GO>}

So Michael, first, we operate in activity-based model with respect to payroll, which is our largest operating cost. And so that naturally decreases as volume decreases. More importantly, we operate with a degree of financial flexibility in our P&L, and that financial flexibility allows us to manage as we think is appropriate in any given environment.

So we have room to manage, and we're confident that we can take share in any environment and manage this P&L wisely per the environment. With respect to any old benchmarks we may have given, we're beyond that. We have financial flexibility in our model. And again, we would flex to sort of meet the circumstances as we would see them.

Q - Michael Lasser {BIO 7266130 <GO>}

That's helpful. Thank you so much, and good luck.

A - Ted Decker {BIO 16614891 <GO>}

Thank you.

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Operator

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

Q - Simeon Gutman {BIO 7528320 <GO>}

Hey, everyone. My first question is, if we could talk a little more detail around the intent and the backlog that was just mentioned. Curious, if you're seeing demand come through, because supply was constrained, there's some pent-up projects versus what the backlog or pipeline continues to build.

A - Richard Mcphail {BIO 19175260 <GO>}

Well, I think you can just start with some survey results. These are public and these are published by the National Association of Homebuilders. This is a survey that goes back to 2001. And the survey, if you bear with me, just sort of says, our conditions -- are you optimistic or pessimistic, 50 being kind of the medium mark here.

So for the 20 years up to 2020, that optimism index never got above a 58. Today, it stands at an 86. So that is the sentiment of the remodeler. With respect to backlog that is also surveyed, that number over the past 20 years never got above a 64. Today, it stands at an 84. Both of those sentiment numbers are all-time highs.

Q - Simeon Gutman {BIO 7528320 <GO>}

Fair enough. And maybe a follow-up. You mentioned home price appreciation being the most important lever. It looks like the home prices in Canada are starting to turn a bit, and the business seems to be holding up well. Can you talk about if that relationship holds or if the same dynamic, the macro conditions for the customer exists and that's why that -- the business is sort of breaking away from that trend?

A - Ted Decker {BIO 16614891 <GO>}

Well, yeah, our Canadian business. I'm not as up to speed, Simeon, on the Canadian stats that Richard just went through for the US. But our Canadian business is in terrific shape. I mean, remember, they had much more significant lockdowns last year. Ontario, in particular, our stores were closed in the first quarter, and we had curbside pickup only. So the business is very, very strong. I don't have as much detail on the relationship with home prices.

A - Richard Mcphail {BIO 19175260 <GO>}

Well, but let's just sort of reflect on something. So last Q1, as a company, we reported a 31% comp. Canada was higher than that. So we had a tougher comp in Canada. And this quarter, our comp in Canada was higher than company average.

Q - Simeon Gutman {BIO 7528320 <GO>}

Thanks.

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Operator

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

Q - Michael Baker {BIO 4323774 <GO>}

Okay. Two. One, simply, can you just quantify, if there's any way to quantify, the weather impact the late spring? How much of that hurt April? And what should we expect that to contribute into May? And then I'll have a follow-up question.

A - Ted Decker {BIO 16614891 <GO>}

So for the quarter, Michael, we think it was about 1%, the negative impact to comp sales in Q1.

Q - Michael Baker {BIO 4323774 <GO>}

And presumably, most of that occurs in April. Is that fair to say?

A - Ted Decker {BIO 16614891 <GO>}

Yes. Yeah, because February, it's not spring anywhere and it's our lowest-volume month. So yes, that's April-driven. As Richard said in his notes, March was more of a stimulus impact, as well as a weaker spring in the south. And then as you started to move toward northern markets, particularly cold weather in April and for the quarter, 1%.

Q - Michael Baker {BIO 4323774 <GO>}

Yeah. We have all felt that cold weather up here in the Northeast, although it's getting better now. I also wanted to follow up on the home price appreciation question. We've all looked at this for many years, and I think most people get that home price appreciation, is that important. How concerned are you that higher interest rates eventually slow down existing home sales? And we've seen that decline 3 months or 4 months in a row, such that the record home price appreciation that we're seeing eventually has to slow down, particularly as the Fed keeps raising rates. And so how big of a concern is that, as you think about the rest of the year?

A - Richard Mcphail {BIO 19175260 <GO>}

Well, I think, we're in a unique position now in recent housing history, where we have built a chronic shortage of housing units in the US consistently and steadily for the last 10 years. Some economists assume that, that shortage is a little less than 2 million. You hear numbers as high as 4 million. If you take other estimates of what will likely be built, we're looking at, at least five years, if not seven years or eight years, before we could actually get back to a point of equilibrium. So we believe that supply and demand are going to be the main drivers of support for home price appreciation. And we know that, that chronic undersupply is going to be a condition for quite some time.

Q - Michael Baker {BIO 4323774 <GO>}

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Okay. Yeah, thanks. Appreciate your comments on that.

A - Richard Mcphail {BIO 19175260 <GO>}

Thanks.

Operator

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

Q - Chris Horvers {BIO 7499419 <GO>}

Thanks. Good morning. So on the seasonality sort of lens as you think about the year, you mentioned shifting of the bathtub effect in the second quarter. It looks like the guide doesn't assume that this above average seasonality that you saw in the first quarter despite a late spring holds. You're actually sort of degrading the seasonality going forward. So I guess, my first -- the two questions, are you expecting a full bathtub effect into the second quarter? And then, why -- is there any reason why you wouldn't think normal seasonality could hold through the back half?

A - Ted Decker {BIO 16614891 <GO>}

Good morning, Chris. Yeah, I would -- we certainly don't think it's going to degrade. I would say, posting the results that we posted with a very cold and wet spring certainly exceeded our expectations. And as commented earlier, we haven't generally raised guidance after the spring, because we say bathtub effect. And too early into Q2, at the time of this call to make a determination. But the first quarter beat our expectation by such an extent, even with the poor weather, we felt necessary to raise to the 3% for the year.

We haven't taken a specific of a view of Q2. I mean, we know at least the 1% is going to flow into Q2. We generally get back all of our spring sales in Q2, even tracking back to the two or three worst early spring, since I've been at Home Depot. But it is still just so early, and our largest weeks are ahead of us. So we don't want to get too far over our skis, but we're certainly not anticipating the degradation of that normal bathtub effect.

Q - Chris Horvers {BIO 7499419 <GO>}

Got it. And then my follow-up question is, a number of vendors have indicated more price increases are coming. Can you talk about how much of the ticket increase was inflation? How are you expecting inflation to play out over the year? Like, we just sort of flatten out as we lap through more price as -- over the next year? And do you expect units to turn positive as the year progresses? Thank you.

A - Ted Decker {BIO 16614891 <GO>}

Right. So I'll start and then Jeff will give a little bit more detail. Yes, as I mentioned earlier, inflation is higher than we had expected to the extent about 2 times. The 11-odd percent ticket was the vast majority of that was inflation-driven. It is impacting transactions, but as we said, not to the extent that we would have thought. So that's all good.

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We have taken costs this year, and there is more on the table. Transportation, we've just finished up our ocean contracts. That's a global contract cycle that goes into effect in May. So those are in place for the next 12 months. Those are certainly higher on a contract basis from 2021. So we think inflation doesn't go up necessarily from where we are. But that it would hold steady at this, call it, double-digit, low 10-ish percent in our product categories through the balance of the year.

In terms of the impact on transactions, we're going to have better transaction results in Q2, just given spring. When you think of the number of transactions in our garden business in the spring time, that's just a tremendous amount of transactions. And we feel very good that we'll get those in Q2. And then lumber was -- it's been on a bit of a seesaw and was high on average to last year in Q1 and we saw that in negative transactions in lumber. But now we're down quite a bit, and we're down about 35% in lumber prices year-over-year. So we expect to pick up in Q2, in particular, in lumber activity. In terms of the balance of the year and how we think about managing through this, I'll let Jeff provide some more color.

A - Jeff Kinnaird {BIO 19649706 <GO>}

Yeah. Thank you, Ted and good morning. Look, we are -- to Ted's comments, we are managing through an inflationary environment, about 2 times what we expected in the first quarter. And we see some continuation of that. We are working with our supplier partners on managing through this inflationary environment. We've had long-standing relationships with many of our suppliers, and it's a partnership to understand the ongoing complexities of the inflation we're seeing.

What we are doing is, we are still the customers' advocate for value in our business. And if you look at the value that we're offering across the spring categories, across the entire business, it is exceptional. If you look at the project business, we are pleased with what we're seeing in project-related demand, inclusive of some of the inflation that we have experienced across the organization. And again, as the customers advocate for value, we have the tools and the capabilities to manage our broader portfolio strategy and manage the inflationary environment. So very pleased with the partnership across the business to manage this inflationary environment.

Q - Chris Horvers {BIO 7499419 <GO>}

Thank you.

Operator

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

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Good morning, everyone. So with the One Home Depot supply chain strategy, you guys are effectively moving into some new markets or certainly expanding your presence in certain verticals and expanding your TAM. Is there any way to potentially size the impact that some of these new markets are having on your results, be it -- whether it's MRO, large

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Pros, et cetera, and maybe places where you weren't as competitive just a couple of years ago?

A - Richard Mcphail {BIO 19175260 <GO>}

Yeah. Generally speaking, we are excited about what we're building out in terms of capability and our ability to go after the repair and remodeler planned purchase occasions that we haven't necessarily been able to in the past. But when you start thinking about contribution to results, we're building an ecosystem here for the Pro. It's not just about fulfillment and delivery. But it's about an online experience that we think is second to none that's seen incredible traction over the very short-term. We have a relationship with our Pros in the store that we think is second to none.

And Hector, I'll turn it to you for a second with some detail. But again, with respect to results, we're quite pleased that we grew by $40 billion over the last two years. We were really pleased that we were able to comp the comp and enter into a second quarter so far with two strong weeks. And I think over the coming years, you're going to see every element of our model add up to our ability to take market share in any environment.

But Hector, maybe you'll talk a little bit about the Pro.

A - Hector A. Padilla {BIO 19175124 <GO>}

Yeah, Richard. And Scot, we are building capabilities to attract more of the Pro planned purchase. Every one of those Pro planned purchase help us pull a lot of the other occasions out of our stores. So when Richard talks about the ecosystem, it is about enabling capabilities across all channels to remove friction from the transactions and experiences from our Pros in every instance. We are super encouraged from the early signs that we're seeing on the commercialization of the supply chain investments that we're making. And the team is super encouraged and involved and engaged.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Okay. Thanks, guys.

A - Ted Decker {BIO 16614891 <GO>}

And Scot, I would add on the MRO piece in the TAM. We couldn't be happier with the combination of our legacy Interline HD Pro business with Home Depot Supply. So not only did we combine the number 1 and 2 players in that industry, but the Home Depot Supply had additional verticals that our business didn't participate in. So we think the TAM in that MRO market essentially doubled to about $100 billion, and we still sit with less than 10% share.

The capabilities that we're building, combining those two businesses, we're well on our way of combining sales forces, getting customers oriented to one legacy customer sales force or the other. We're beginning to integrate the supply chains. What we're able to do now in MRO for multifamily housing is incredibly robust and then new verticals, hospitality in particular, as travel has come back. In the hospitality, occupancy rates are going up. That business is just booming. So we love our position in MRO in the verticals we're in. And Shane O'Kelly and his team are just doing a great job of that business.

A - Richard Mcphail {BIO 19175260 <GO>}

I think, just to the TAM point, we talked about the 130 million households in the US, about 30 million of those households actually occupy multifamily dwellings. And so that HD Supply acquisition opened up that TAM for us and is a unique attribute of The Home Depot.

Q - Scot Ciccarelli {BIO 1495823 <GO>}

Excellent. Thanks a lot guys.

Operator

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

Q - Karen Short {BIO 7215781 <GO>}

Hi, thanks very much. Wondering if you could just give a little bit more color on puts and takes for 2Q to 4Q, with respect to gross margin and SG&A, I guess, in the context of assuming inflation remains at the current level. And then also a bit more context on how you think traffic and ticket will shake out for the full year? And then I have one other question.

A - Richard Mcphail {BIO 19175260 <GO>}

Sure. So for the year, we believe that gross margin, if you just sort of stay mix-neutral, gross margin will see slight pressure from the investments we're making in One Supply Chain. Those have been planned all year, and we've expected that for a while.

With respect to operating expense leverage, as we have taken our sales guidance up, we've also raised our operating margin guidance. That reflects the operating expense leverage we expect to generate on those incremental sales.

With respect to ticket and transaction, we assume that comps in the back half are positive. If inflation persists for the year, persist at current levels, we expect ticket could be in the range of 10% to 12% for the year, offset by transactions to net out to a three comp for the year.

Q - Karen Short {BIO 7215781 <GO>}

So I guess, a question on that, my follow-up would be -- I mean, investors are focused on your two -- one year, two year, three year traffic trends. And I appreciate there's a labor efficiency component with negative traffic to some extent. But at what point does the traffic on a multiyear basis maybe start to concern you?

A - Ted Decker {BIO 16614891 <GO>}

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Well, this is definitely a unique year for sure in our ticket and transaction dynamic. As I stated earlier, we do look for a balance between ticket and transaction. And we usually plan that growth will come from more or less an equal mix of ticket and transaction. With the -- two fundamental things going on, Karen. One, we're -- to your point on two year and three year stacks, we're comping off the $40 billion of sales growth that Richard commented on. And in Q1, at a 31% comp, the highest comp in the longest time at Home Depot.

And to comp that, we didn't plan on, to comp that is a huge positive. Now the balance isn't the norm for sure, again, a unique year with this level of inflation, 10-odd percent. But the customer's engagement is much more resilient than we would have thought. That's why we hit -- we knew the inflation going into the year, and we knew the potential impact to transactions.

The level of activity in our space, and I have talked about the backlog and the intents, it is really helping offset that and the consumers staying more engaged. Now as we lap through these extraordinary comps from the $40 billion of growth and certainly, hopefully lap through the inflation, we would get back to the balance that we would certainly prefer.

Q - Karen Short {BIO 7215781 <GO>}

Okay. That's helpful. Thank you.

Operator

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

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Q - Zachary Fadem {BIO 18911015 <GO>}

Hey, good morning. Ted, following up on your comment that Q1 beat your expectations, could you talk about the extent that was Pro driven versus DIY or other pockets of your business? And then as you think about the second half of this year, to what extent do you incorporate stable Pro trends? And could they offset a more variable DIY, if the macro or inflationary environment softens from here?

A - Ted Decker {BIO 16614891 <GO>}

Sure. I would start by saying in, even our Pro traffic is consumer-driven, right? I mean, all projects fundamentally on the Home, we certainly have trades in our business, buying product for servicing other spaces than the home. But the vast majority of our activity is supportive of the home. And whether it's a consumer buying themselves or a Pro, the Pro is buying ultimately for a consumer's home.

So with that being said, though, yes, Pro is stronger than we would have thought. I mean, that's where the beat came from. Our Pro is incredibly strong. And we're so optimistic of, as Hector outlined, ecosystem we're building. We just continue to gain momentum with that Pro customer and certainly offset more of an as-expected consumer. When you think of spring as a consumer business in terms of garden, we don't have large penetrations in Pro in our garden business, so that is consumer-driven. And then the stimulus is really

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impacting the consumer. I mean, we all have heard plenty of anecdotes about consumers getting their check last March -- truly going to buy a new power tool or a new lawnmower. So that was what was unique about the consumer.

In terms of the trend over time, not just the intent that Richard talked about in the ecosystem, that Hector talked about, but what we love with our Pro customer and the confidence we continue to build in what's happening is, when we look at our comps with our Pro customers, we get a stronger progression of comps with the Pro from what we call an unplanned purchase in store, which is still a strong comp, but sequentially going up to higher and higher comps as we get to a planned delivered purchase. So think of that Pro who's just coming to the store to do cash-and-carry in an unplanned purchase versus one who we know is staging out a project and getting that project delivered. The sequence of comps of that engagement gets higher and higher and higher, with the highest being planned delivered.

Also, when you think about the engagement with our loyalty models in our engagement with our sales forces, again, while still positive, our Pros who are not in our loyalty program, buying a cash-and-carry unplanned purchase, while positive that is the lowest comp going all the way through to a Pro, who's in the loyalty program, who's purchasing with us on an interconnected basis and is managed by an outside sales contact, those (Technical Difficulty) by far, have the highest comp within the Pro. So we just love this ecosystem that we're building, the engagement that we're starting to see, the sequential strength of comps as these Pros get more engaged with us. And yes, we think those Pro trends are going to keep powering the business.

Q - Zachary Fadem {BIO 18911015 <GO>}

Thanks, Ted. That's helpful. And then for Richard, with your inventory growth outpacing sales growth for the past four quarters by a pretty wide margin, how do you think about your position here, in terms of having enough inventory or too much inventory? And with the slower start to spring that you called out, how should we think about the potential impact of higher promo on the gross margin line?

A - Richard Mcphail {BIO 19175260 <GO>}

So first of all, we're -- we took steps, as Ted had said earlier in the call, to invest in improving our in-stock position. And while we're not -- we're quite where we were pre-pandemic, we are the healthiest we've been in the last few years. So if you think about sort of that pull-forward of inventory, making sure that we landed inventory early, because in this business, customer service starts with being in-stock. And you also consider the impact of a late spring. That really makes up about half of the increase in inventory, and the other half is simply the impact of inflation.

So as we think about this through the year, obviously, we're -- as spring kicks in, we'll see that inventory begin to reflect the seasonality. And we work hard. Our merchants and our supply chain team and our vendor partners work hard to make sure that we have an advantaged position.

Q - Zachary Fadem {BIO 18911015 <GO>}

All right. Thanks. (Multiple Speakers)

A - Ted Decker {BIO 16614891 <GO>}

Just a comment on the promotional activity. We did shift an appliance event into May, driven by the Easter following mid-April. As I commented, thrilled with the performance of our appliance business as we finish the event in May. At this point, we don't focus on promotions at all. Our focus is providing everyday value for our customers. That has been multiple years of progression, and we're thrilled with the value we're providing every single day in terms of being priced right every day, driving great innovation and driving a great experience for our customers.

Q - Zachary Fadem {BIO 18911015 <GO>}

Thanks for the time.

A - Ted Decker {BIO 16614891 <GO>}

You're welcome.

Operator

Our next question comes from the line of Steven Zaccone with Citi. Please proceed with your question.

Q - Steven Zaccone {BIO 19950127 <GO>}

Great. Good morning, everyone. Thanks for taking my questions. Maybe a follow-up about consumer spending towards the home, since it's been discussed in detail here. Clearly, you're seeing strong demand from ongoing projects. I think investors are trying to grapple with the fact that home spending may slow at some point, because of the macro. But the home also has increased importance post-pandemic. What's your take on that debate? Do you think that makes home improvement spending more recession-resistant than it's been in the past?

A - Richard Mcphail {BIO 19175260 <GO>}

Well, we really just have to look at the health of our customer today, which is strong. And we also have to listen to our customers, those same surveys where the Pro survey, there's also one with respect to consumer intent to do projects. Homeowner intent to do projects of small, medium and large sizes has never been higher than right now.

Q - Steven Zaccone {BIO 19950127 <GO>}

Got it. Very helpful. Then just shifting, could you talk about capital allocation priorities if the macro environment were to get a bit choppier? How do you balance capital investment, share buyback and the potential for M&A? And I guess, specific to M&A, it's been 18 months since you did the HD Supply acquisition. Would you be open to additional M&A in the next few years to reach your higher TAM? How best to think about the criteria?

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A - Richard Mcphail {BIO 19175260 <GO>}

Well, with respect to capital allocation, we generate strong free cash flow and so have returned significant capital to shareholders over the last decade-plus. With respect to CapEx and investment in the business, we take a long-term view. We are always going to invest ahead of the customer. We are always looking years ahead to make sure that we build the best customer experience in home improvement. And so that would likely be our stance. But we always have to take circumstances into consideration, and we do that in any event.

A - Ted Decker {BIO 16614891 <GO>}

And on M&A, we've always maintained an active strategic business development group, and they're always looking in the marketplace for companies really regardless of size, generally on the smaller size, that can add capabilities. So you've heard us talk about some various data shops we've acquired. Certainly, the larger acquisition of supply helped us into a market space. And that is an ongoing review that we're active looking at capabilities and market spaces that an acquisition can help accelerate our development in that space.

Q - Steven Zaccone {BIO 19950127 <GO>}

Great. Thank you very much.

A - Isabel Janci {BIO 16473072 <GO>}

Christine, we have time for one more question.

Operator

Thank you. Our final question will come from Chuck Grom with Gordon Haskett. Please proceed with your question.

Q - Chuck Grom {BIO 3937478 <GO>}

Hey, good morning. Thanks for let [ph] me in. Great results and congrats, on the inflation front, curious if you're seeing any unit demand destruction as you've been taking retails higher. Or is there any signs of trade-down in the basket? Walmart called that out this morning, and I know your basket is obviously very different than theirs. Just wondering, if you're seeing anything on that front.

A - Ted Decker {BIO 16614891 <GO>}

No. Chuck, good morning. We're seeing no trade-down in the environment, and we're thrilled with the innovation that we're offering to our customers. Ted commented -- as I commented earlier, we're seeing trade-up for innovation. We're seeing a lot of activity around our consumers looking to improve their homes, to adopt new innovations. I talked about the electrified lawnmower business and the opportunity there. That's just one example of -- many examples of trade-up. And then on the project business, we're seeing great demand. As we commented earlier on the project business, both for the Pro and for the consumer.

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Q - Chuck Grom {BIO 3937478 <GO>}

Okay. That's great to hear. And then one for Richard. Can you flesh out the expectation for comps in the front half to be better than the second half? If I look at your compares on a three year geo stack, they're pretty consistent. Just wondering if you're being conservative there, or I guess, the expectation for the trend to slow a little bit in the last six months of the year?

A - Richard Mcphail {BIO 19175260 <GO>}

It's early. What I would say is, we do expect Q2 to be the highest-comp quarter of the year. And expect the first half to be higher than the second half, but we do expect positive comps through the year.

Q - Chuck Grom {BIO 3937478 <GO>}

In the back half. Okay, great. Thank you.

Operator

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

A - Isabel Janci {BIO 16473072 <GO>}

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

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..

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