

## Q3 2017 Earnings Call

### Company Participants

- Carol B. Tomé, Chief Financial Officer & Executive Vice President-Corporate Services
- Craig A. Menear, Chairman, President & Chief Executive Officer
- Diane Dayhoff, Vice President-Investor Relations
- Edward P. Decker, Executive Vice President-Merchandising
- Kevin Hofmann, Chief Marketing Officer & President-Online
- Mark Holifield, Executive Vice President-Supply Chain & Product Development
- William G. Lennie, Executive Vice President-Outside Sales & Services

### Other Participants

- Alan Rifkin, Analyst
- Brian Nagel, Analyst
- Christopher Horvers, Analyst
- Chuck Grom, Analyst
- Daniel Thomas Binder, Analyst
- Dennis Patrick McGill, Analyst
- Kate McShane, Analyst
- Matthew J. Fassler, Analyst
- Matthew McClintock, Analyst
- Michael Louis Lasser, Analyst
- Scott A. Mushkin, Analyst
- Seth I. Sigman, Analyst
- Simeon Ari Gutman, Analyst

## MANAGEMENT DISCUSSION SECTION

### Operator

Good day, ladies and gentlemen, and welcome to The Home Depot Q3 2017 Earnings Conference Call. Today's conference is being recorded.

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

**Diane Dayhoff** {BIO 15757035 <GO>}

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

Following our prepared remarks, the call will be opened for analysts' 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 will also include certain non-GAAP measures. Reconciliation of these measures is provided on our website.

Now, let me turn the call over to Craig.

### **Craig A. Menear** {BIO 15126612 <GO>}

Thank you, Diane, and good morning everyone. Sales for the third quarter were \$25 billion, up 8.1% from last year. Comp sales were 7.9% from last year and our U.S. stores had a positive comp of 7.7%. Diluted earnings per share were \$1.84 in the third quarter, up 15% versus last year.

I'm incredibly proud of our performance given that this quarter was one marked by an unprecedented number of natural disasters, from hurricanes and flooding to earthquakes and wildfires. Our thoughts and prayers continue to be with all of our associates and communities who are directly impacted. As they always do, our associates and suppliers did an incredible job supporting those in the paths of these natural disasters. They worked tirelessly and under difficult circumstances to get product where it needed to be, often as they too faced disruption in their own lives.

Though our store teams worked tirelessly to reopen stores as quick as possible in the wake of these events, several of our stores, particularly in the areas like Puerto Rico, St. Thomas and St. Croix, were forced to remain closed for an extended period of time. Our solid performance in the quarter was driven by outstanding execution across the entire organization, though our results were not solely due to storm-related activities.

We saw a broad-based growth across our geographies. Every region posted positive comps in the quarter, but the storms did impact the variability in performance across the regions. Internationally, both Mexico and Canada posted another quarter of positive comps in local currency.

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As Ted will detail, both tickets and transactions grew in the quarter, as we saw growth not only in storm-related product categories, but in core categories as well. We saw a healthy balance of growth from both our pro and DIY categories, with pro sales once again outpacing DIY sales in the quarter. We believe that the work we're doing to enhance the service capabilities for the unique needs of the pro customer continues to resonate.

Our interconnected strategy continues to drive sales both in stores and online, as online sales grew approximately 19% in the quarter, now representing approximately 6.2% of our total sales, with approximately 45% of our online U.S. orders being picked up in our stores. And should a customer need to return an item purchased online for another item, our conveniently located stores are there for them, with 85% of our online order returns being completed in-store.

For fulfillment options beyond the store, we continue to see great results with our store delivery which grows every week. We are also currently piloting other delivery options, which we'll talk to you about in more detail at our Investor Conference in December. The flexibility of our supply chain is a competitive advantage for our business, a fact that was particularly evident given the unpredictability of demand associated with this quarter's natural disasters. And while our supply chain did a fantastic job keeping impacted stores in stock, they did so while continuing to support the business in non-disaster-impacted areas as well.

So, while this was a unique quarter for us, I am encouraged by the underlying health of the core business. From a macro perspective, we continue to see positive signs in the housing data, which we believe serves as a tailwind for our business. As Carol will detail, because of our outperformance in the third quarter and the expectation of additional sales from the rebuilding efforts associated with the storms, we are increasing our sales and earnings per share guidance for the year.

I want to close by thanking all of our associates, especially our store associates, for their hard work and continued dedication to our customers and communities. Helping in a time of need is a core part of The Home Depot culture and that is exactly what our associates did this quarter. We are very proud of their efforts.

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

**Edward P. Decker** {BIO 16614891 <GO>}

Thanks, Craig, and good morning everyone. We had a great third quarter, driven by strength in our core business. We also saw incremental demand stemming from the natural disasters during the quarter. I'd like to thank our cross-functional teams and supplier partners for their efforts in mobilizing our response. These efforts allowed us to get product to our communities at their time of need.

We had five departments record double-digit comps in the quarter. This included lumber, appliances, electrical, indoor garden and tools. Building materials and flooring were also above the company's average comp. Decor, hardware, paint, millwork, plumbing, kitchen,

bath and outdoor garden were positive, but below the company average. Driven by price deflation, lighting was slightly negative.

In the third quarter, we saw growth in both ticket and transactions. Comp average ticket increased 5.1% and comp transactions increased 2.7%. Commodity price inflation in lumber, building materials and copper positively impacted average ticket growth by approximately 105 basis points. Foreign exchange rates also positively impacted average ticket growth by approximately 41 basis points.

Big ticket sales in the third quarter or transactions over \$900, which represent approximately 22% of our U.S. sales, were up 12.1%. The increase in big ticket sales was driven in part by strength in appliances, vinyl plank flooring, special order carpet, and several pro-heavy categories. Transactions for tickets under \$50, which make up approximately 16% of our U.S. sales, grew by 1.8% in the quarter.

In the third quarter, we saw strong sales with both our do-it-yourself and professional customers. Sales to our professional customers grew double digits in the quarter, with similar growth rates in both our high-spend and low-spend pros. Pro-heavy categories such as lumber, wire, insulation, gypsum and hand tools, all had double-digit growth during the quarter.

Storm-related categories also saw significant growth, with double-digit comps in generators, wet/dry vacs, tarps and ladders. In response to the storms, our merchandising execution, field merchandising and supply chain teams worked together to make real-time decisions to adjust our product assortment and inventory levels. This allowed us to better stage product and optimize our store footprint.

Looking beyond the storm-related demand, we continue to see momentum in our core business. Comps in non-impacted markets remained strong, with healthy growth in both ticket and transactions. During the quarter, we hosted several events that helped drive traffic and create excitement in our stores. We were pleased with our annual Halloween, harvest and Labor Day events, which recorded strong growth year-over-year.

Now, let me turn our attention to the fourth quarter. In our constant pursuit of being the product authority in home improvement, we continue to focus on bringing new and innovative products to market that save our customers both time and money. One area where we continue to demonstrate this product authority is with lithium-ion cordless power tools, and now we are on the forefront of bringing this technology to adjacent categories.

In the fourth quarter, we are excited to introduce the most powerful cordless compressor in the marketplace. The DEWALT FLEXVOLT cordless air compressor offers all the convenience and portability of cordless, and allows our customers to continue using the pneumatic tools they already own. Each battery charge provides our customers the power and run-time they need to complete a variety of projects. This new DEWALT FLEXVOLT cordless air compressor is a big box exclusive to The Home Depot.

Adding to our incredible lineup of professional-grade power tools, we are excited to introduce a new product lineup from Makita that offers an even more powerful cordless solution for a multitude of tools. The new Makita LXT product line offers 36-volt power to a fresh lineup of recip, circular and miter saws, as well as grinders. With these tools, our pros will be able to tackle any job faster and with up to 50% more run-time. This new and advanced lineup of power tools is also a big box exclusive to The Home Depot.

With fall coming to an end and the winter season rapidly approaching, our associates are preparing for another series of exciting events. In the fourth quarter, we will host our Black Friday and holiday events along with our best gift center ever. Our gift center will consist of incredible values and products from the best brands such as Milwaukee, DEWALT, Ryobi, Makita, Diablo and Husky just to name a few.

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

## **Carol B. Tomé**

Thank you, Ted, and good morning, everyone. Before I discuss our third quarter results in detail, I would like to take a minute to touch on the impact of the three hurricanes that affected our business in the quarter.

First, we saw increased demand as customers prepared for and started to recover from these events. We also experienced store and DC closings. In fact, we had 236 stores closed for some period during the quarter. We estimate that hurricane-related sales positively impacted total company comp sales growth by approximately \$282 million in the quarter. These sales were in lower-margin categories like plywood and generators, and we had additional supply chain costs. So, our gross margin on the hurricane-related sales was considerably less than our company average.

Finally, we experienced roughly \$104 million of hurricane-related expense in the quarter for items like people cost, increased security in our affected stores, and storm damage. So, while our year-over-year sales growth was positively impacted by the hurricanes, our operating profit was negatively impacted by \$51 million.

In the third quarter, total sales were \$25 billion, an increase of 8.1% versus last year. A weaker U.S. dollar positively impacted total sales growth by approximately \$102 million or 0.4%. Our total company comps or same-store sales were positive 7.9% for the quarter with positive comps of 7.7% in August, 9% in September, and 7.2% in October. Comps for U.S. stores were positive 7.7% for the quarter with positive comps of 7.3% in August, 8.8% in September, and 7% in October.

In the third quarter, our gross margin was 34.6%, a decline of 17 basis points from last year. While there were many factors that drove our gross margin performance in the quarter, we can isolate the year-over-year change to the impact of the hurricane-related sale.

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In the third quarter, operating expense as a percent of sales decreased by 54 basis points to 19.9%. As I previously mentioned, during the quarter we had approximately \$104 million of hurricane-related expenses. Backing out the sales and expenses associated with the hurricane, our operating expense as a percent of sales was better than our plan. Our operating margin for the third quarter was 14.7%, an increase of 36 basis points from last year.

Interest and other expense for the third quarter grew by \$11 million to \$247 million, reflecting a higher long-term debt balance versus last year, offset somewhat by higher interest income. In the third quarter, our effective tax rate was 36.9% compared to 36.2% in the third quarter of fiscal 2016. Our diluted earnings per share for the third quarter were \$1.84, an increase of 15% from last year.

Now moving on to some additional highlights. During the quarter, we opened one new store in Mexico for an ending store count of 2,283. Total sales per square foot for the third quarter were \$412, up 7.9% from last year.

Turning to the balance sheet, at the end of the quarter, merchandise inventories were \$13.4 billion, up \$178 million from last year, and inventory turns were 5.2 times, up two-tenths from last year.

In the third quarter, we repurchased approximately \$2.1 billion or 12.3 million shares of our outstanding stock. This included 5.6 million shares on the open market and 6.7 million shares repurchased through an accelerated share repurchase or ASR program. For the shares repurchased under the ASR program, this is an initial calculation. The final number of shares repurchased will be determined upon completion of the ASR in the fourth quarter. For fiscal 2017, we're now targeting share repurchases of \$8 billion, of which \$2.1 billion will occur in the fourth quarter.

During the quarter, we took advantage of an attractive interest rate environment and raised \$1 billion of long-term debt, of which \$500 million was used to repay debt that came due in September. Computed on the average of beginning and ending long-term debt and equity for the trailing 12 months, return on invested capital was approximately 32.5%, 340 basis points higher than the third quarter of fiscal 2016.

Turning to our outlook for the remainder of the year, we continue to see underlying strength and momentum in our core business. The macro environment remains supportive, and we believe housing is a tailwind for our business. In addition, we expect the hurricane recovery efforts to continue across a number of our markets.

As a result, today we are lifting our fiscal 2017 sales and earnings per share growth guidance. We now expect fiscal 2017 sales to increase by approximately 6.3%, with positive comps of 6.5%. We now expect our fiscal 2017 gross margin to decline by approximately 12 basis points. For the year and reflecting the expense impact of the hurricanes, we now expect our expenses to grow at approximately 55% of our sales growth rate. And finally, for the year, we expect our effective tax rate to be approximately 36.3%.

For earnings per share, remember that we guide off of GAAP. For fiscal 2017, we now expect diluted earnings per share to increase by approximately 14% to \$7.36. We look forward to talking with you at our Investor Conference on December 6 in Boston where we will give you an update on our key strategic initiatives and our long-term financial targets.

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

## Q&A

### Operator

Thank you. We'll first go to Michael Lasser with UBS.

#### Q - Michael Louis Lasser {BIO 7266130 <GO>}

Good morning. Thanks a lot for taking my question.

#### A - Craig A. Menear {BIO 15126612 <GO>}

Morning.

#### Q - Michael Louis Lasser {BIO 7266130 <GO>}

So, how long do you expect the hurricane-related spending to impact your sales results? And how is the trajectory going to look? Is it initially the greatest right around the event and then it tails off over time, or will it be pretty consistent over the course of the period that you expect to have an impact?

#### A - Craig A. Menear {BIO 15126612 <GO>}

Hey, Michael. We certainly expect, as Carol called out, to see continued sales increase from the hurricane as we move into 2018. It'll be pretty much in the first half we think.

#### A - Carol B. Tomé

Yeah. So, we have a lot of experience with hurricanes and we see that Hurricane Harvey was much like the Baton Rouge flooding last year. Hurricane Irma is much like Superstorm Sandy, although on a smaller scale, and Hurricane Maria, well, it's much like Katrina, although on a smaller scale. And what our past experience tells us is that the hurricane-related sales tend to be the highest in the quarter immediately following the quarter in which the hurricanes occurred and then they tail off over time. As Craig said, we would expect them to tail off throughout 2018.

For the purposes of building our forecast and guidance today, we have hedged back some of the anticipated hurricane-related sales in the fourth quarter, because it's the fourth quarter and anything can happen with weather. I will tell you based on the first two weeks of our sales in November, our forecast would appear to be conservative, but it's a

good thing to put together a conservative forecast. When we look at the year-on-year impact, we would expect, as Craig mentioned, that there would be no comp DWIT (20:43) next year as a result of the hurricanes. We would have the same amount of hurricane sales in 2018 as we had in 2017.

**Q - Michael Louis Lasser** {BIO 7266130 <GO>}

Carol, do you want to explicitly tell us what the amount of hurricane-related spending that you expect in the fourth quarter?

**A - Carol B. Tomé**

I would not like to specifically tell you that.

**Q - Michael Louis Lasser** {BIO 7266130 <GO>}

Okay. I thought I would try. And then, I forget it was Craig or Ted, one of you gave us a little tease about the analyst meeting and talking about new delivery options that you're piloting. If you were to go free shipping on some dollar threshold across all of your online SKUs, how margin dilutive would that be to your overall P&L? It looks like you've got, out of your top 150,000 items right now, you've got about 6,800 that would qualify for free shipping. So, what if you went kind of across the board, how margin dilutive would that be?

**A - Craig A. Menear** {BIO 15126612 <GO>}

Michael, today we offer free shipping on any order over \$45, so the majority of everything we ship today falls under free shipping.

**Q - Michael Louis Lasser** {BIO 7266130 <GO>}

Okay. Great. Thank you so much.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Sure.

**Operator**

Our next question comes from Charles Grom with Gordon Haskett.

**Q - Chuck Grom** {BIO 3937478 <GO>}

Thanks. Good morning. I'm just wondering if you guys could speak to the quarterly progression of sales, excluding the hurricane impact throughout the - not only in the U.S., but worldwide?

**A - Carol B. Tomé**

Well, we didn't go back and recalculate the cost, but just let me tell you the impact of the hurricane-related sales and then you can do the math. We project - not project, but we



have seen that the hurricane-related sales in August were about \$10 million, the hurricane-related sales in September were about \$150 million, and the hurricane-related sales in October were about \$120 million.

**Q - Chuck Grom** {BIO 3937478 <GO>}

Okay. Yeah, we could do the math there. Great. And then, when you look ahead and try to quantify the impact of the top line, I'm just wondering when you think about the gross margin profile of these sales going forward, how historically has it played out? Obviously, here in the third quarter they were significantly lower than you would typically see it, but how do they progress going forward?

**A - Craig A. Menear** {BIO 15126612 <GO>}

When you think about the kind of prep sales, if you will, that largely happens as you move into a storm, you're selling things like plywood and generators which are very low-margin rate goods. As you move past that and get into cleanup and recovery, you then begin to see a more normalized mix of sale across the business, and it depends again on the type of storm that it is. And that has a tendency to be more normalized margin in the business.

**Q - Chuck Grom** {BIO 3937478 <GO>}

Okay. Thanks very much, and good luck.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Sure. Thanks.

**Operator**

Thank you. We'll now hear from Dan Binder with Jefferies.

**Q - Daniel Thomas Binder** {BIO 1749900 <GO>}

Thanks. Good morning.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Good morning.

**Q - Daniel Thomas Binder** {BIO 1749900 <GO>}

You talked a little bit about product innovation, specifically the battery technology. Connected home has also been an emerging category. It seems like a natural fit for a few different retailers out there, one has been particularly aggressive. I'm just curious if you could give us some thoughts on how Home Depot is positioned to benefit from that.

**A - Edward P. Decker** {BIO 16614891 <GO>}

Yeah, Dan. It's Ted. I think we're very well positioned. We have quite a bit of product that's selling very nicely with strong growth year-over-year. I'm most excited right now about

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some of the new thermostat product coming out from Nest. We have great innovation coming from Ring. We've been partnering with Ring for some time. They've given us a number of launch exclusives as well as nuanced product exclusives. I think that speaks to their confidence in Home Depot's ability to bring that type of product to market and sell it.

But we're experimenting with how we display the product. As you know, we're a working warehouse, so how to get that product aggregated in a series of bays with different merchandising approaches is something we're working on, and happy with the number of different formats we're utilizing right now.

**Q - Daniel Thomas Binder** {BIO 1749900 <GO>}

Great. And then as - for my follow-up question, a separate topic on credit. I know you don't own your credit portfolio, but just wondering if you can provide us with some color on how that portfolio is doing, if there's an increase in lending, willingness to lend, delinquencies, write-offs, things of that nature.

**A - Carol B. Tomé**

Yeah, thanks very much. So, you're right, we don't own our credit portfolio, but we do have visibility into the portfolio. It's a very healthy portfolio with an average net receivable of \$12.6 billion. As we look inside the portfolio, we see that it's performing nicely. Our loss rates are up slightly year-on-year, but they're considerably under the historical average. The historical average, just to put in perspective, is 4.3%.

In terms of approvals for customers applying for our private label credit card, we see on the consumer side that 73% of all applications are being approved with a FICO of around 750. So, we write a pretty high quality here. On the pro side, 72% of all applications are being approved, and for the pro, that line is around \$6,700. So, hopefully that's helpful.

**Q - Daniel Thomas Binder** {BIO 1749900 <GO>}

Yes. Thank you very much.

**A - Carol B. Tomé**

Yes.

**Operator**

And we'll continue on to Simeon Gutman with Morgan Stanley.

**Q - Simeon Ari Gutman** {BIO 7528320 <GO>}

Good morning. Nice quarter. Can you diagnose the health of the do-it-yourself versus the do-it-for-me customer, if you're seeing any changes in frequency or ticket? And I ask because there's a lot of focus on the ticket and traffic breakdown as if there's something to be gleaned about the cycle based on how the customer segments are behaving.

**A - Edward P. Decker** {BIO 16614891 <GO>}

We actually see growth across both the pro categories, the do-it-for-me categories and the DIY categories. And we've seen a sequential improvement in the small ticket quarter-over-quarter, tickets below \$50, which have a tendency to lean more towards DIY as well. And the large ticket growth continues as a result of strong pro business and categories like appliances and roofing and flooring. So, not really seeing anything that has us concerned at all about the DIY business.

**A - Carol B. Tomé**

Or do-it-for-me.

**A - Edward P. Decker** {BIO 16614891 <GO>}

Right.

**A - Carol B. Tomé**

No.

**A - Edward P. Decker** {BIO 16614891 <GO>}

Not any one.

**Q - Simeon Ari Gutman** {BIO 7528320 <GO>}

Okay. And my follow-up, just two parts. First, if we get a cold winter this year, does that represent a tough compare in any way since we've had a couple warm winters? And does it change any complexion of margin for the next couple quarters? And then the follow-up or the second part was just, can you comment on the online sales? It looks like the trajectory slowed, I'm curious why.

**A - Craig A. Menear** {BIO 15126612 <GO>}

In terms of the weather, if you will, what happens is some categories will do better in cold weather, other categories will not. So, we've had the benefit of project business through warm winters, but then that actually puts pressure on your categories in the cold weather type things, like heaters and so on. So, it's really a balancing act, one offsets the other.

**A - Carol B. Tomé**

And that's why we tend to look at our business on the half and not the quarters, because there always are these weather-related year-over-year compares and we have this bathtub effect that we've talked to you about in the first half that always occurs. On the margin, the margin is what the margin is based on where the sales are, but no real pressure coming at us.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Right. We were actually pleased with our growth online. Kevin is here. I'd let him comment.

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**A - Kevin Hofmann** {BIO 19136140 <GO>}

Yeah, we saw real strength in our flooring business, our blinds and window coverings businesses, our bath business. And as Carol mentioned, we had a number of stores that had days they were closed due to the hurricane impacts and that actually affected some of our online penetration in those stores, but that was really the only thing that caused a blip in the quarter for us.

**A - Carol B. Tomé**

Yeah. The sales growth was \$243 million year-on-year, so we were pleased with that. And just to put the store closings into perspective, they were closed a cumulative 809 days, which is the same as having 2.2 stores closed for an entire year.

**Q - Simeon Ari Gutman** {BIO 7528320 <GO>}

Right. Well, thank you.

**Operator**

Christopher Horvers with JPMorgan has our next question.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

Thanks. Good morning.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Morning.

**A - Carol B. Tomé**

Morning.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

So, I wanted to follow up on the expenses. So, it looks like ex the hurricane top line and bottom line SG&A impact, you grew SG&A to sales at about a 39% growth rate. How do you think about that ratio as you look forward in the business? I know you typically sort of guide to 50% and there's always a kind of productivity opportunity at The Home Depot. Do you think that 50% is still the right number? Or is 40% the right number? Do you see any upward pressure on your sort of marginal flow-through around SG&A versus sales?

**A - Carol B. Tomé**

Well, let's just look at the fourth quarter and, as you know, we don't guide on the fourth quarter, but I'll give you some color on the fourth quarter. The expense growth factor in the fourth quarter will be similar to what we've guided for the entire year. And as you know, we've now lifted our guidance such that the expense growth factor should be 55% for the entire year and you may say why is that? Well, a few reasons. One, we will have some ongoing hurricane-related expense not to the extent that we experienced in the

third quarter, but there is some natural disaster expense that's going to happen in the fourth quarter.

Two, we are significantly outperforming our plan, which is a good news story and that means we're going to be paying more bonuses, so we'll have more success sharing for our hourly associates. And we're delighted with that, but that will put some pressure on the expense growth factor in the fourth quarter.

And then there's just a little bit of currency nuance in all of this because when you have a weaker U.S. dollar, your expenses outside the United States when you translate them back actually are a little bit higher than it would have been last year. So, hopefully that helps guide what the fourth quarter would look like. And then as you know, we've got our Investor Day coming up on December 6 and we're going to give new financial targets for 2020, so we'll grind you through everything on such things.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

I guess - but as you think about, it seems like if I look back in 2016 you grew, I think, 30% relative to sales. So, does that indicate any sort of upward pressure on incremental cost versus sales?

**A - Carol B. Tomé**

Yeah. You recall at the beginning of the year we said 50% was a good number to use and that included rising people costs. I mean, we're not alone. All retailers are faced with rising people costs and we view our people as an investment, so we have some of that pressure. But, Chris, at the end of the day, the operating margin this company wants to lift in a BAU basis. We will leverage expense in a BAU basis and if you want to use 50% as a BAU number, that's a good number to use.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

Understood. And then just curious about your crystal ball, you talked about no DWIT (32:23) from the hurricanes as you look to next year. It seems like there's a bigger hurricane this year versus last year, so what gives you the confidence in saying that at this point? I guess why not let the Street put the DWIT (32:39) in there? What are you seeing that would motivate you to guide that way this far out?

**A - Craig A. Menear** {BIO 15126612 <GO>}

I mean as we've shared, each storm is different and Harvey was very different than the other two storms. And the situation in Harvey is a much more protracted recovery because of the nature of the storm being water-based and the fact that there were a fair amount of folks that didn't have insurance because they didn't live in a 100-year floodplain. Unfortunately, they were in a 500-year floodplain. And so we just think that that recovery is going to be protracted. And in a storm like that, you have to go in and basically people are ripping everything up down to the studs and starting over. That's going to take a while to recover.

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**A - Carol B. Tomé**

We have - I've got a 10-page deck that - well, if you work for us, I'd tell you. And I'm not going to tell you. But if we look at Harvey as an example, it really looks so much like the Baton Rouge flooding, but it's 3.7 times bigger than the Baton Rouge. So, we just modeled our experience in Baton Rouge, kind of multiplied it by three point times to get the effect for this year and into next. There's actually a lot of science that went behind this expectation, but I appreciate the suggestion that maybe we should put a DWIT in (34:09) but I'm not hoping to, but I appreciate the suggestion.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

So, it's a first half versus back half 2018, basically?

**A - Carol B. Tomé**

Yeah. Exactly. Exactly.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Yeah. We'll be good in the first half. There'll be - yeah.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

Understood.

**A - Carol B. Tomé**

Yeah.

**Q - Christopher Horvers** {BIO 7499419 <GO>}

Thank you very much.

**Operator**

Thank you. We'll continue on to Seth Sigman with Credit Suisse.

**Q - Seth I. Sigman** {BIO 17751557 <GO>}

Thanks. Good morning, and nice quarter. I wanted to follow up on the pro business, nice to see that comps continue to grow in the double-digit range. I realize it's tough to isolate, but as you think about some of the initiatives in place, whether it's credit or delivery or integrating the Interline catalog, can you maybe point to where you're seeing utilization of some of those offerings is starting to increase and what you think is really driving some of that traction? Thank you.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Bill?

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**A - William G. Lennie** {BIO 15126222 <GO>}

Seth, this is Bill Lennie. It really - I'd say that the pro business is on a broad base of strength, whether it's the project business that continues to be strong, as well as a good balance between ticket and transaction. But we have made some enhancements to our Pro MyView (35:19) system in the store which gives our PASAs or Pro Account Sales Associates a better view into their customers and better insights on where to reach for category expansion and how to get a better engagement with our customers.

I think the acquisition of Compact Power is another area where we can increase the engagement with our pros. And we know that the more that we get that multilevel engagement, whether it's online, whether it's delivery, whether it's any one of our other services, that we do increase the reach into the customers' wallet and we do start to see growth in the share of the customers' business. Then on top of that, we're also seeing an increase in the number of pros that are shopping our stores as well. And we've got solid performance against categories, against FCC codes and increasing pro customer engagement.

**Q - Seth I. Sigman** {BIO 17751557 <GO>}

Okay. Thank you for that. And then just as a follow-up, as you think about the housing outlook, one of the things we've observed is a pickup in home ownership among millennial consumers. If we assume that continues and that's going to become an increasingly important demographic for the business over time, can you just give us a sense of what you're seeing, if there's anything different in terms of behavior for that customer group and some of the things you're doing to try to target that customer base? Thank you.

**A - Edward P. Decker** {BIO 16614891 <GO>}

Sure. We're actually not seeing a ton of difference. Obviously, if you think about new home ownership, some of the things that happened early on in that is categories like paint, categories like outdoor garden where they're beautifying their home. Those are the simpler projects that begin and that kind of takes place no matter what age group is buying the home. But we're very pleased with the trend. This is something that we saw in our research, that millennials would, in fact, step into home ownership. It was just a delayed cycle and that is playing out. And we think that bodes well for the housing market going forward.

Also, our research says that, as Craig said, the types of projects that they're going to engage in are very similar to any new homeowner and in research, we see that the millennial is showing an interest to be DIYers as well, so actually a quite keen interest to do the projects themselves.

**Q - Seth I. Sigman** {BIO 17751557 <GO>}

Great. Thank you very much.

**Operator**

Thank you. Our next question will come from Brian Nagel with Oppenheimer.

**Q - Brian Nagel** {BIO 6638066 <GO>}

Hi. Good morning. Nice quarter. With regard to the hurricane sales we've talked a lot about, and I know this might be a little near term in focus, but is there any way to measure - clearly Home Depot stepped up nicely here in its efforts to help customers, but how your market share tracked in these events versus what you would normally consider market share trends from the business?

**A - Craig A. Menear** {BIO 15126612 <GO>}

Yeah, we really have no way of knowing that. It's just - it's happening, it's unfolding right now, we just don't have any way of knowing that.

**Q - Brian Nagel** {BIO 6638066 <GO>}

Okay. That's fair. The second question I had with regard to online, again we called it out as a growing, but still a small portion of the business. As online continues to evolve, is there any surprises here with regard to maybe what your customers are buying online? And then also, how should we think about just the investment needed to continue to support the online initiatives? Thanks.

**A - Craig A. Menear** {BIO 15126612 <GO>}

As it relates to any surprise in the online, I think, probably the thing I'd say there is we shared several years back our bubble chart, if you will, in terms of how we thought the online business would play out by categories, and there was a group of businesses in the lower left of that chart that we thought wouldn't have much influence. I think the thing that we've now realized is the shopping experience in almost every category starts in the digital world and it truly is an interconnected experience going forward. So, we're paying attention to the digital representation across all of our business as we go forward, creating an interconnected experience, if you will, the one Home Depot experience for each category and that's probably the big, I'd say, learning from a few years back that we've had.

**A - Edward P. Decker** {BIO 16614891 <GO>}

To build on that in a bit, Craig, you mentioned our bubble chart listing all our key categories and looked at what is the intensity of inquiry, online and then matched against the actual purchase behavior. And the purchases haven't changed that much. The large categories that were large three years ago are large today. It's a lot of bath, a lot of lighting, a lot of power tools, et cetera. Those continue to be big businesses. But some of the most heavily engaged, again as Craig said, we're not going to get a lot of purchasing online with pro commodity, we see the highest engagement online is with our pros checking inventory levels and price. So, again a very interconnected shopping experience. They're still then going to the store, but they want to make sure everything is there for their project before they go to the store.

**A - Carol B. Tomé**



And so that means we have to continue to invest in the experience and at our Investor Conference on December 6, we will lay out our investing plans.

**Q - Brian Nagel** {BIO 6638066 <GO>}

So, I look forward to that. Thank you very much.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Thanks.

**A - Carol B. Tomé**

Thank you.

**Operator**

Alan Rifkin with BTIG has our next question.

**Q - Alan Rifkin** {BIO 1493714 <GO>}

Thank you very much, and congratulations on a great quarter.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Thanks.

**Q - Alan Rifkin** {BIO 1493714 <GO>}

First question for Craig. Craig, you mentioned that the flexibility of your supply chain continues to be an asset benefiting you. Can you maybe just provide a little bit more color on exactly what you are doing there in the sustainability of things?

**A - Craig A. Menear** {BIO 15126612 <GO>}

Sure. And I also have Mark Holifield here, too. He can jump in, but I'd say the investments that we've made in creating the core components of our supply chain, our RDC or rapid deployment network, has been a significant advantage in our ability to flow and point goods where it needs to be. And it all starts there. And, Mark, I don't know if you want to add on to that, but?

**A - Mark Holifield** {BIO 5952851 <GO>}

Well, our focus continues to be on creating a fastest and most efficient supply chain in home improvement and to do that, we're planning and collaborating much more with our vendors through our Sync initiative using our truckload resources much more capably filling our trucks and building our productivity within the four walls of our distribution centers and really synchronizing the whole flow of the supply chain to achieve that. And we've had great results in working with our suppliers to make that happen.

**A - Craig A. Menear** {BIO 15126612 <GO>}

I guess just one last comment that I'd have on that, Alan, is Ted called out our field merchandising team. They play a key role in these type of situations, where they truly become the field general on the battlefield, if you will, in a sense and help direct and point the supply chain and the merchants' efforts. And that's a key component of what we do as well.

**Q - Alan Rifkin** {BIO 1493714 <GO>}

Okay. Thank you. And just a follow-up if I may for Carol. Inventories at \$13.4 billion, up about 1.3%, substantially lower than your revenue growth. What effect from the hurricane, if any, was there on your inventory levels? And can you maybe just provide, Carol, some commentary on if those levels are satisfactory to you right now? Thanks.

**A - Carol B. Tomé**

Well, the impact of the hurricane on the entire supply chain was enormous and the team did an awesome job of redirecting products to get it to our stores and our customers in need. In terms of our inventory levels, our inventory turnover, we're very pleased where we are. We've worked really hard to drive productivity and inventory and that starts with the products that we source, the great associates who sell them and then how to flow them through our supply chain.

One of the initiatives that we've been investing in is something we call supply chain, we think, which lowers the variability and improves the predictability of orders. One of the desired outcomes was higher inventory productivity and we're seeing that. So, we're very happy. Long-winded answer to say we're happy with our inventory levels.

**Q - Alan Rifkin** {BIO 1493714 <GO>}

Great. Thank you very much.

**A - Carol B. Tomé**

Thank you.

**Operator**

Thank you. And Matthew McClintock with Barclays. Please go ahead.

**Q - Matthew McClintock** {BIO 16452505 <GO>}

Hi, yes. Good morning, everyone. Carol, you said that you will leverage expenses. In the past, you've said that there's always a natural tendency for your gross margin to want to lift, but you reinvest back in value. And I guess my question is, how do you think about your future growth algorithm coming from further reinvestments in value versus, maybe, investments in the store experience or investments in deliveries? How should we kind of segment the growth going forward from those two buckets? Thank you.

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**A - Carol B. Tomé**

Thank you for asking the question. We're devoting a good part of our Investor Day on December 6 to talk about the future and how we parse through that. There's a BAU point of view and then there will be an investing point of view and we'll share with you both to give you a real clear understanding of what we're going to be doing over the next several years.

**Q - Matthew McClintock** {BIO 16452505 <GO>}

Okay. I'll look forward to that.

**A - Carol B. Tomé**

Sorry to kick the can down the road, but we've got an Investor Day in just a few weeks.

**Q - Matthew McClintock** {BIO 16452505 <GO>}

Not trying to steal your thunder in any way.

**A - Carol B. Tomé**

Okay. Thank you.

**Q - Matthew McClintock** {BIO 16452505 <GO>}

But if I could ask a follow-up then, just on Dan's question regarding connected home. On appliances specifically, how do you think about evolving the selling model of appliances as they become more connected and how to think about tying that into your broader connected home offerings? Thank you.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Well, we're very engaged that the product manufacturers are really coming up with some terrific innovation. We're working with them closely. We have a view into the pipeline of what's coming. We integrate then with other products in the store. As we've said before, we're very much an open-source platform where any of our products can work with any other products through an agnostic hub.

So, yeah, we think we're in a great spot. We added a lot to our online collateral to showcase all products, but in particular appliances. It's a category we've put a lot of effort into, lots of photos and 360-degree spin and features and measurements and how to get ready for installation, a home delivery model, and contacting the customer the day before and then hours before the actual installation. So, it's all part of our end-to-end thinking and business model development for appliances.

**Q - Matthew McClintock** {BIO 16452505 <GO>}

Great. Thanks a lot, and look forward to seeing everyone.

**A - Carol B. Tomé**

Thank you.

## Operator

We'll go to Kate McShane with Citi.

**Q - Kate McShane** {BIO 7542899 <GO>}

Hi. Good morning. Thank you for taking my question.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Morning.

**Q - Kate McShane** {BIO 7542899 <GO>}

My question was on Interline. Now, that Interline is integrated and your salespeople are able to access that inventory for The Home Depot customer, how much do you think that is contributing to comp? And how much do you think there's room to ramp that business up in a more meaningful way at the store level?

**A - Craig A. Menear** {BIO 15126612 <GO>}

First of all, let me start with we're very excited about the Interline business and we continue to work the integration of that business, and we're pleased overall with the direction and results we're seeing in that. And, Bill, I'll let you...

**A - William G. Lennie** {BIO 15126222 <GO>}

So, Kate, we really have two initiatives rolled out into the stores. The first one is pro MRO, which gives the pro customers shopping in our stores access to the Interline catalog and we're seeing that engagement in those sales ramp week-over-week in a nice fashion right on target to where we would expect them to be. Key categories for engagement with the pros are running in plumbing, electrical, HVAC, and hardware. So, it's right down the center of that and the core of the business.

And then the second initiative is our ProPurchase card which I would really describe as a pro access card. It gives the Interline customers access to shop our stores and with the swipe card have their purchases billed back onto their accounts, and we're seeing that adoption rate ramp back up. We were off to a light launch for that, but it's trending nicely and we're pleased with both initiatives and then when we're together in December, we'll talk about some next steps and next phases.

**A - Carol B. Tomé**

Given the size of our company, it's hard to see that all those success flowing through on the top line in a measurable way right now, but the trend is right. The trend is positive, and the opportunity set is big. As we've described, the addressable market in the MRO space is \$50 billion, and we're just scratching the surface there, so there's a lot of room to grow.

**Q - Kate McShane** {BIO 7542899 <GO>}

Thank you.

**Operator**

Thank you. And we'll continue on to Dennis McGill with Zelman & Associates.

**Q - Dennis Patrick McGill** {BIO 6299739 <GO>}

Hi. Good morning and thank you. First question, I guess, Ted, on the storm recovery, what you saw in October, I guess, maybe tail end of October into November, are there categories that you could call out as seeing a disproportionate benefit from some of the repair items?

**A - Edward P. Decker** {BIO 16614891 <GO>}

Well, I think if you look at the categorization of the two storms, as Craig said, both are very similar in the preparation. You're doing plywood to board up windows, and you're getting generators and water, et cetera. And then when the storm hits, a lot of things like outdoor tools and chainsaws and debris removal.

After that, the flood in the more Houston market, there you're literally ripping the floor to the studs. So, you have wiring and wiring devices and gypsum and mud and paint and flooring, quite a bit of flooring product, also cabinetry and appliances, et cetera. With the storm in Florida that went up the coast, that's more exterior damage, say, roofing and gutters, some windows, shutters, exterior paint, and things like that. So, we see the duration of the storm much more out of Houston as we get into the interior fit-and-finish of flooded-out homes.

**Q - Dennis Patrick McGill** {BIO 6299739 <GO>}

Okay. That's helpful. And then, Carol, on the holiday side, that's been an area in the fourth quarter the last several years where you've been able to generate some solid upside, and you talked about maybe being conservative on the hurricane side of things. How would you frame the holiday side within the forecast and any additional color you can provide on what might be different this year, exciting this year that would create another lift on top of last year's success?

**A - Carol B. Tomé**

Yeah. Well, we plan to comp last year's outstanding results, and we're going to do that, and maybe we have a conservative forecast. So, maybe even a bit better.

**A - Craig A. Menear** {BIO 15126612 <GO>}

We're pleased with the early results.

**A - Carol B. Tomé**

We sure are. The first two weeks of November have started off very strong.

**Q - Dennis Patrick McGill** {BIO 6299739 <GO>}

All right. Thanks. Good luck, guys.

**A - Carol B. Tomé**

Yeah.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Thank you.

**Operator**

Thank you. Scott Mushkin with Wolfe Research. Please go ahead.

**Q - Scott A. Mushkin** {BIO 7138867 <GO>}

Hey, guys. Thanks for taking my questions. So, I just wanted to – I mean after that last comment about how strong things are in November, I just want to know, outside of the hurricane areas, did you guys want to give us a U.S. comp?

**A - Craig A. Menear** {BIO 15126612 <GO>}

No, I don't think we'll do that, but I can tell you this. Our business, if you look at the business in areas not affected by hurricanes, I mean we're actually very pleased with the business, both from a transaction standpoint, a ticket growth standpoint, growth in key categories across the business. We see strength across the store and across geographies, as we said in our earlier comments. So, we're very pleased with the trends in the business right now.

**Q - Scott A. Mushkin** {BIO 7138867 <GO>}

And would you be comfortable calling it sequential strength?

**A - Craig A. Menear** {BIO 15126612 <GO>}

Yeah. I mean...

**A - Carol B. Tomé**

Sure.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Yeah. And if you look at it as well on a two-year stack basis, sure.

**Q - Scott A. Mushkin** {BIO 7138867 <GO>}

Okay. Then the one thing (52:57) we had a lot of questions, but one thing that hasn't been talked about and we get a lot of questions on is tax policy. Obviously, with the rollout of the House plan, we saw a little step-back in some of the home-related hard-lining names,

and I just wondered if you guys had a thought as we go into 2018 about tax policy. Where we are in the cycle? Generally, that's the kind of question we get, too. And if you have any fears as we move into 2018, that we could actually see a slowdown in your business, ex the hurricanes. Thanks.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Sure. So, on a broad basis, I'd say we're very supportive of tax reform that would fuel the economy and create jobs. And so, that's something that we hope we see take place here. And I think there's obviously a lot going on between the House and the Senate. We'll see where this all falls out.

As it relates to some of the pieces that are being discussed individually and how that impacts housing, candidly, we don't subscribe to the fact that we believe the mortgage interest deduction elimination would have much of an impact. I mean we just don't think it has much, and in large part because the majority of households wouldn't have an impact from what's described today. But it's pretty early to tell. We don't know what's going to get passed.

**A - Carol B. Tomé**

It's early days. Our research shows that only 23% of tax filers actually use the deduction. And then of the people who have mortgages, only 5% have mortgages in excess of \$500,000. And then if you have to think about, well, what is the impact to those who actually have mortgages in excess of \$500,000 who might itemize and use deductions, it's really based on that marginal tax bracket.

And the way to think about it (54:53) cost of their mortgage. And with mortgage rates so low, it's not a material impact. In fact, we know that for every 25 basis points increase in mortgage rate, it's \$40 a month. So, you can do the math. You can come up with your own impact. But we just don't - as we stand here today, don't think there'll be a material impact.

As we think about housing broadly and fears of slowdown, we don't see that for 2018, 2019 and 2020 for a number of reasons. We've talked about an aging housing stock, household formation and home price appreciation, and you may say, well, home prices are really hot, haven't they fully recovered peak to trough? Well, yes, they have, but on an inflation basis, they're still down double digit.

And when you think about the wealth effect that's been created with higher home prices, there's been about a 122% increase in equity or about \$64,000 per home, and that's translating into spending in the home. And the forecast for home price appreciation next year is very good. So, we don't - the rumors of our impending slowdown, we don't see because we look at the underlying data and then we look at what happens in our stores every day and on our website, and we just don't see it.

**A - Diane Dayhoff** {BIO 15757035 <GO>}

Catherine...

**Q - Scott A. Mushkin** {BIO 7138867 <GO>}

Thanks.

**A - Diane Dayhoff** {BIO 15757035 <GO>}

...we have time for one more question.

**Operator**

Thank you. Our final question will come from Matt Fassler with Goldman Sachs.

**Q - Matthew J. Fassler** {BIO 1509751 <GO>}

Thank you so much for fitting me in. Good morning. Two kind of clean-up questions on a couple of tactical items. First of all, obviously, it's a tough quarter to discern the significance of moves in individual line items, but if you could talk about how you think the storm impacted your traffic numbers versus your ticket numbers during the quarter.

**A - Craig A. Menear** {BIO 15126612 <GO>}

So, again, when - Matt, when we looked at the business across regions and looked at non-storm areas versus storm areas, the data around tickets and transactions is actually pretty comparable. And we didn't see a dramatic departure. Obviously, Houston, that market is up and up significantly. But when you look at regions which are, give or take, 100 stores, we don't see a big departure in the numbers, storm versus non-storm.

**Q - Matthew J. Fassler** {BIO 1509751 <GO>}

And then secondly, we didn't talk much about the promotional environment. Obviously, the gross margin ex the impact of the storms looked very clean. Your appliance business was quite strong, and you didn't seem to pay a price for that. Anything noteworthy in the market, particularly relative to the first half of the year?

**A - Craig A. Menear** {BIO 15126612 <GO>}

Yeah, we see a pretty similar promotional cadence. Most people's Black Friday ads are out and it's pretty much right on last year, so maintaining the current promotional environment.

**Q - Matthew J. Fassler** {BIO 1509751 <GO>}

That's helpful. Thank you so much, guys.

**A - Craig A. Menear** {BIO 15126612 <GO>}

Yeah.

**A - Diane Dayhoff** {BIO 15757035 <GO>}

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Well, thank you all for joining us today, and we look forward to meeting with you at our Investor Conference in Boston on December 6.

## Operator

Thank you. Ladies and gentlemen, once again, that does conclude today's conference. Thank you all again for your participation. You may now disconnect.

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