Company Name: Home Depot
Company Ticker: HD US
Date: 2018-11-13
Event Description: Q3 2018 Earnings Call

Market Cap: 204,812.18
Current PX: 179.01
YTD Change($): -10.52
YTD Change(%): -5.551

Bloomberg Estimates - EPS
Current Quarter: 2.170
Current Year: 9.644
Bloomberg Estimates - Sales
Current Quarter: 26651.652
Current Year: 108356.867

Q3 2018 Earnings Call

Company Participants

- Isabel Janci
- Craig A. Menear
- Edward P. Decker
- Carol B. Tomé
- Mark Holifield
- Ann-Marie Campbell

Other Participants

- Christopher Horvers
- Michael Lasser
- Brian Nagel
- Charles P. Grom, Jr.
- Simeon Ari Gutman
- Matthew McClintock
- Steven Forbes
- Seth I. Sigman
- Scot Ciccarelli
- Elizabeth L. Suzuki
- Jonathan Matuszewski
- Scott A. Mushkin

MANAGEMENT DISCUSSION SECTION

Isabel Janci

Non-GAAP Financial Measures

Today's discussion will also include certain non-GAAP measures

Craig A. Menear

Business Highlights

Sales and Diluted EPS

- We were very pleased with our results in the quarter
- Sales for Q3 were up 5.1% from last year to $26.3B
- Comp sales were up 4.8% from last year, and our U.S. comps were positive 5.4%
- Diluted EPS were $2.51 in Q3

By Geography

- From a geographic perspective, sales were strong across the U.S.
- All but one of our 19 regions posted positive comps
- The exception was our Gulf region, which faced tough compares associated with the anniversary of Hurricane Harvey
- Recall that we are lapping almost $300mm of hurricane-related sales from Q3 last year
- While this quarter brought hurricanes Florence and Michael, the scope of devastation was more compact from a geographical perspective than what we experienced in prior year
  - Nonetheless, these storms did inflict significant damage in our community, and our thoughts and prayers are with them as they began the recovery efforts
  - Our thoughts and prayers also go out to all those who are currently being impacted by the deadly fires in California
- Internationally, both Canada and Mexico posted positive comps in local currency
- As Ted will detail, both ticket and transactions grew in the quarter
- Pro sales once again outpaced DIY sales, but we continue to see a healthy balance of growth from both pro and DIY customers as they shop across the store
  - We believe this is a testament to the overall strength of demand in the home improvement market

Digital Business

- Our digital business continues to be another source of growth
- Online traffic growth was healthy, and third quarter online sales grew approximately 28% from Q3 2017
- Customers continue to respond to ongoing investments and enhancements we are making to drive a frictionless interconnected customer experience
  - For example, Buy Online Ship to Store and Buy Online Pick Up in Store sales both grew faster than the overall online sales growth rate for Q3

Investments, Supply Chain and Fulfillment Options

- Another key component of the best-in-class interconnected shopping experience centers on enhanced delivery and fulfillment options
- As you know, we are in the very early stages of a five-year investment journey in the One Home Depot supply chain to enable the fastest, most efficient delivery network in home improvement
- Today we can reach approximately 95% of the U.S. population in two days or less with parcel shipping
- The anticipated end state of the One Home Depot supply chain will enable us to reach 90% of the U.S. population with same-day or next-day delivery capability for an extended SKU offering that includes big and bulky goods
  - In order to get there, we must invest in a number of different facilities to offer greater depth and breadth of SKU availability

- We told you that 2018 would be the year of the pilot as we test and learn with new fulfillment centers
- I am pleased to report that we are on track with our plan and we are live with our first few pilot facilities, with additional pilots scheduled to open throughout the rest of this year and early next year

Store Delivery Enhancements

- As we work on our long-term initiatives, we are also focused on meeting our customers' immediate delivery needs
- We have made great progress with our store delivery enhancements, as our car and van express delivery offerings now enable same-day delivery of store goods
- Since rolling out car and van delivery to over 40% of the U.S. population, we have seen increased utilization from both our pro and DIY customers

Customer Service, Productivity and Simplifying Operations

- As we continue to work towards the 2020 goals that we laid out for you in December of 2017, let me update you on some of our investments, all of which focus on delivering exceptional customer service, driving productivity, and simplifying operations
- We have implemented our Wayfinding sign and store refresh package in approximately 700 stores, ahead of our initial plan
- We continue to make progress on the rollout of our redesigned front-end areas and pickup lockers, among other investments

New Overhead Management Application

- We are also working to remove friction for our customers while helping our associates to be more productive with their time
- An example of this is the deployment of our new overhead management application
- As you've heard us say before, customer service starts with being in stock
- But beyond just having the product in stock, it has to be on the shelf for our customers to purchase, not stored in an overhead
- Prior to the rollout of the overhead management application, the only way an associate could locate product in our overheads was to manually look for it
  - This new application on FIRST Phones helps associates locate product in overheads quickly and accurately, saving them time, improving the customer experience, and enabling better inventory management

Outlook

Sales, Diluted EPS and Investments

- Turning to our outlook, as Carol will discuss in more detail, we are updating our sales and earnings guidance for the year
- We now expect FY2018 sales growth of approximately 7.2% and diluted EPS of $9.75

- We faced the headwinds from last year's storm-related sales in Q4, but we believe that drivers of home improvement spend are supportive of our business
- We remain excited about the investments we are making to ensure that we deliver the best customer experience in home improvement

Closing Remarks

I want to close by thanking our associates for their hard work and continued dedication to our customers

Our associates not only work hard to serve our customers in our aisles, but their efforts extend to the communities in which we operate

This quarter marked our eighth annual Celebration of Service campaign, in which our associates volunteered over 100,000 hours in support of veteran housing needs

In fact, our associates and non-profit partners have been hands-on in transforming over 40,000 veteran homes and facilities since 2011

We are very proud of our associates who live our values every day

And given that Veterans Day was earlier this week, let me take this opportunity to thank those that have served our country

Edward P. Decker

Q3 Highlights

Performance

- We were pleased with our results in Q3
- The core of our store continues to perform well, and we saw growth with both our pro and DIY customers
- Looking at our departments, comps in appliances, electrical, plumbing, tools, décor, and flooring were above the company average
- All of our other departments but lighting were positive but below the company average
- The comp in lighting was essentially flat
- In Q3, comp average ticket increased 3.5% and comp transactions increased 1.2%

Commodity Prices, Inflation and Foreign Exchange Rates

- Commodity prices were volatile in the quarter
- While inflation in lumber, building materials, and copper positively impacted average ticket growth by approximately 61BPS in the quarter, today lumber prices are below 2017 levels
- In addition, foreign exchange rates negatively impacted average ticket growth by approximately 43BPS

Big-Ticket Projects

- We continued to see strength in big-ticket projects during the quarter

- Big ticket sales or transactions over $1,000, which represent approximately 20% of U.S. sales, were up 9.1% in Q3
- A few drivers behind the increase in big-ticket sales were vinyl plank flooring, windows, appliances, and water heaters

Pro-Heavy Categories

- Once again, we saw strong performance in many pro-heavy categories, as pro sales grew faster than the company's average comp
- Pro-heavy categories like power tools, concrete, and several plumbing and electrical categories all had comps above the company average

DIY Customer

- We also continue to see a healthy and growing DIY customer, as they engaged with us across the store
- Categories like safety and security, vanities, lawn mowers, ceiling fans, and interior and exterior paint showed strong growth in the quarter
- In Q3, 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 solid growth y-over-y

MET

- As we continue to focus on enhancing the in-store experience for our customers, I'd like to highlight some recent initiatives we have been working on with MET, our Merchandising Execution Team
- This seasoned team manages set integrity and executes resets throughout the store, bringing best-in-class speed to market
- MET leverages advanced analytics and proprietary technology to drive productivity and efficiency in our stores
- We use real-time data to understand what categories require attention and leverage our FIRST Phones to direct the work activity of our MET associates

Supplier Partners

- We want to thank our supplier partners who continue to see the power of partnering with The Home Depot
- Our suppliers entrust us with many exclusives and innovative product launches, in large part because of our 400,000-plus orange-blooded associates and the enthusiasm they bring to our isles every day
- Two recent additions to our portfolio of exclusive brands are Stanley hand tools and Troy-Bilt outdoor power equipment
    - Adding Stanley to our lineup of Milwaukee, DEWALT, Husky, Crescent, Empire, Wiss, Bessey, and Klein exclusive brands makes us the number one destination for hand tools
    - And Troy-Bilt complements our leading lineup of exclusive outdoor power equipment brands, including Ryobi, Toro, Honda, Cub Cadet, ECHO, EGO, DEWALT, and Milwaukee

- In fact, 14 of the 15 top-rated gas self-propelled lawnmowers in the market are big-box exclusives to The Home Depot

Q4 Guidance

Looking to Q4, we are excited about the upcoming holiday season

In addition to our comprehensive holiday décor offerings, we are thrilled with our 2018 Gift Center

- This Gift Center is our best yet and features a number of special buys from our leading tool and power tool accessory brands that are also exclusive to The Home Depot, including Ryobi, RIDGID, Milwaukee, Makita, Diablo, and Husky

Carol B. Tomé

Financial Highlights

Sales and Revenue Recognition

- In Q3, total sales were $26.3B, an increase of 5.1% from last year
- Recall that at the beginning of FY2018, we adopted a new accounting standard pertaining to revenue recognition
- The new standard changes the geography of certain items on our income statement, but has no impact on operating profits
  - In Q3, the change in accounting positively impacted sales growth by $64mm
- Further, during Q3 a stronger U.S. dollar negatively impacted total sales growth by approximately $110mm or 0.4%
- Our total company comps were positive 4.8% for the quarter, with positive comps of 6.7% in August, 4.1% in September, and 3.8% in October
- Comps in the U.S. were positive 5.4% for the quarter, with positive comps of 7.5% in August, 4.7% in September, and 4.2% in October

Hurricane-Related Sales

- The cadence of our monthly comps is due in large part to hurricane-related sales
- In Q3 FY2017, we experienced approximately $282mm of hurricane-related sales, and the majority of those sales occurred in September and October
- In Q3 this year, we had approximately $150mm of sales related to both the 2017 and 2018 hurricanes
  - These sales were more equally spread across the quarter
- We estimate that hurricane-related sales positively impacted U.S. comps by 60BPS in August, but negatively impacted U.S. comps by 80BPS in September and 120BPS in October

Gross Margin

- In Q3, our gross margin was 34.8%, an increase of 23BPS from last year

- The y-over-y change in our gross margin reflects the following factors
  - First, the new accounting standard drove $147mm of gross profit, or 47BPS of gross margin expansion
  - Second, higher supply chain and transportation costs caused approximately 23BPS of gross margin contraction
  - And finally, the net impact of all other drivers of gross margin resulted in 1 basis point of contraction
- For the year, we now expect our gross margin rate to expand by approximately 37BPS

Operating Expense, Margin, Interest and Other Expense

- In Q3, operating expense as a percent of sales increased by 23BPS to 20.1% due to the following factors
- First, we experienced 90BPS of expense leverage in BAU, or business as usual expenses
  - Our strong leverage in the core of our business was driven by good expense control but also reflects some y-over-y benefits due to certain hurricane-related expenses that did not repeat this year
- Second, the new accounting standard resulted in $147mm increase to our operating expenses and caused 51BPS of operating expense deleverage
- And finally expenses related to our strategic investment plan of roughly $164mm resulted in approximately 62BPS of operating expense deleverage
- For the year, we now expect our FY2018 operating expenses to grow at approximately 131% of our sales growth rate
- Our operating margin for Q3 was 14.7%, essentially flat with last year
- Interest and other expense for Q3 decreased by $23mm to $224mm, largely due to tax settlements that occurred in the quarter

Tax Rate, Diluted EPS and Inventory

- In Q3, our effective tax rate was 21.4% and for the YTD was 23.3%, lower than last year and our guidance
- The lower rate reflects tax reform and a few other discrete items that were recorded in the quarter, including a reconcilement of the provisional tax charge we recorded in Q4 last year
- For FY2018, we now expect our effective tax rate will be approximately 24%
- Our diluted EPS for Q3 were $2.51, an increase of 36.4% from last year
- Total sales per square foot for Q3 were approximately $434, up 5.2% from last year
- Compared to last year, inventory dollars grew by $1.3B to $14.8B and inventory turns remained at 5.2 times
  - The growth in our inventory vs. last year reflects the investments we are making to accelerate merchandising resets, higher in-stock levels than we had one year ago, and some pull forward of planned inventory purchases

ASR Program and Debt-to-EBITDA Ratio

- In Q3, we repurchased $2.5B or approximately 12.6mm shares of outstanding stock
- We also received approximately 1mm shares related to an ASR program we initiated in Q2

- YTD, we have repurchased approximately $5.5B of our outstanding shares, and we now expect to repurchase approximately $8B of our outstanding shares for the year
- We plan to fund our fourth quarter share repurchases with cash on hand and with proceeds from incremental debt
- In Q4, we intend to replace $1.15B of senior notes that came due in September, and we may raise additional long-term indebtedness, which will take us closer to our targeted adjusted debt-to-EBITDA ratio of 2 times
- Computed on the average of beginning and ending long-term debt and equity for the trailing 12 months, return on invested capital was approximately 42.2%, 970BPS higher than Q3 FY2017

Outlook

Turning to our outlook for the remainder of the year, remember that we have a directionally correct but imperfect model that we use to forecast sales growth

It starts with GDP growth, which is strong

Consumer sentiment remains near all-time highs, and unemployment is the lowest it has been in nearly 50 years

Housing-Related Metrics

- Housing-related metrics are moderating, but the drivers of home improvement spend are supportive of our outlook
- Home prices continue to appreciate
- The housing stock is aging
- Households are being formed, and housing continues to turn over
- And while we see healthy home improvement demand, it is important to note that in Q4, we are up against approximately $380mm of hurricane-related sales

Sales, EPS, Gross Margin, Expenses, Share Repurchases and Tax Rate

- Today, we are updating our FY2018 sales guidance to reflect our YTD outperformance
- We are also lifting our EPS guidance to reflect our expectations for FY2018 gross margin, operating expense, share repurchases, and tax rate
- Remember that we guide off GAAP, and recall that FY2018 will include a 53rd week, so Q4 FY2018 will consist of 14 weeks
- For FY2018, we expect sales to increase by approximately 7.2%, with positive comps as calculated on a 52-week basis of approximately 5.5%
- For EPS, we expect FY2018 diluted EPS to grow approximately 33.8% to $9.75

QUESTION AND ANSWER SECTION

<Q - Christopher Horvers>: There are a lot of questions on the consumer in the home environment and housing. If you look at your fourth quarter guide, it seems like inflation after some remnant benefit in Q3 may be flat, may be a headwind. You also have a harder compare in the hurricane front. So you’re still guiding to about 4.5% for Q4, assuming that the U.S. is going to be better than that because of FX. So what are you seeing in the business? What gives you the confidence to give that level of a guide?

<A - Craig A. Menear>: Chris, I'll give you a high level and let Carol walk you through the details. Again, we see overall the environment for home improvement is solid. We're clearly up against significant hurricane numbers. But as we see it, basically two-year stacked comps would be comparable in H1 and H2 as we look forward. And that's really based on the strength that we see for not only the home improvement factors, but what we have lined up for the back half of the year in terms of events and merchandise and the great Gift Center that Ted talked about, we're excited about what we have going in the back half.

<A - Carol B. Tomé>: That's right, Chris. And we get comfort from our guidance, not only from what we're seeing in the macro environment, but from what we're seeing in our existing sales, and we are pleased with how the quarter has begun.

<Q - Christopher Horvers>: Excellent. So I wanted to fast-forward a little bit on tariff risk. You had the experience with appliances. It looked like you largely passed through those price increases. But as you think about a more broad potential tariff risk to next year, how would you just size up your potential risk? And can you also talk about how you think about investment in share? Some companies have commented that they would try to maintain the gross margin rate. How would you think about balancing gross margin rate versus, let's say, in certain categories, maybe flooring, trying to go after share and drive gross profit dollars?

<A - Craig A. Menear>: Chris, I'll start and let Ted jump in here. We have seen, as you mentioned, we had tariffs impact in laundry, for example. The tariffs that have come through to date represent about 1% of U.S. purchases. And as we see more happen in January, and who knows what's going to happen, but if the 25% were to go in place, that's going to represent about 3.5% of U.S. purchases. And clearly, we'll work to mitigate as much of that as possible. But as you saw in laundry, you will see some impact in prices.

The comment that I would make as it relates to the second part of your question is we run this business on a portfolio basis, and we will do everything we can to mitigate pressure on the customer to the best of our ability. But don't think of us taking cost in one area and that's where necessarily retail gets applied. It's a portfolio approach. We're in the project business.

<A - Edward P. Decker>: Yeah. I would add to that, Craig, it's manageable is the term I'm using, Chris. Certainly, what we've seen today is more than manageable, particularly in the light of that portfolio approach that Craig described.

A couple comments of good news, if you look at what happened with laundry and that's generally a MAP price industry, so the industry did take that price largely attributable to tariffs. We also had steel cost in that as well as just the straight laundry tariff. And while there was an initial reaction to unit productivity, as we've now cycled through that several months, our laundry sales and unit productivity is on par, if not slightly better than the average of our overall appliance business. So we were able to cycle through that and would expect to see the same, again, given the strength of demand in other categories as well.

<Q - Michael Lasser>: So it sounds like your view is that home improvement demand has and will be decoupled from housing. How long do you think that can persist? And what level of home prices and housing turnover would make you rethink that view?

<A - Carol B. Tomé>: So, Michael, I think I – and we would phrase that a bit differently. We have this directionally correct but imperfect model that we use to forecast our sales outlook. As I mentioned, it starts with GDP. And to that, we add the benefits from a number of different housing metrics, including household formation, home price appreciation, the age of the housing stock, and housing turnover. And if we look at those drivers, we think they all bode well for our outlook.

Now our outlook would suggest that our fourth quarter comp will be lower than what we reported in Q3, but that's because we are up against almost $400mm of hurricane-related sales. And while we do expect to get hurricane-related sales in Q4, we don't expect to get $400mm worth of hurricane-related sales. So we factored that into our outlook.

In terms of decoupling, there's one metric that's gotten a lot of attention recently, and that's housing turnover. And if you look at housing turnover, housing turnover is lower than we thought it would be at the beginning of the year when we put together our directionally correct but imperfect model. So we went back and calculated what we believe the impact of lower housing turnover than what we had projected at the beginning of the year, what the impact has been to our outlook. And based on our model, which is not perfect, but based on our model, the impact has been 13BPS.

And then one other correlation number to share with you, at least to the way that we look at the world, we correlated housing turnover with transactions. And we don't do a smoothing approach. We do look at the actual data on a one-month lagged basis. If you look at historical correlation from 2000 to now, the correlation coefficient was 0.53. Okay, but if you go and run it again from 2010 to now, it's 0.4. And if you run it from 2015 to now, it's 0.33. So it's decoupled a bit, we think in large part because of the housing shortage in the U.S. But the way that we're talking about housing metrics is a bit like a Rubik's cube. You've just got to turn it and turn it and turn it until you form a point of view on what it means for home improvement spend.

<**Q - Michael Lasser**>: And, Carol, that's helpful. And because you've guided for the next few years that comps will grow in the 5-ish percent range, so should we think about if housing turnover continues to decline at a similar rate and home prices start to moderate that the risk to that forecast would be in this 13 basis point type range, so it would not be as significant as what would be implied by the headlines from that outlook?

<**A - Carol B. Tomé**>: Again, it's a Rubik's cube. You can't just look at turnover when you're turning the cube around. We would need to refresh our point of view on home price appreciation as well because that's been a big driver of our sales growth for sure. We've seen since 2011, homeowners have had a 140% increase in their equity, now up to $124,000 per unit, so real wealth has been created.

Home prices are projected to increase in 2019, albeit not at the rate that we've seen this year. So we are refreshing our point of view. We're not taking our sales growth targets down because we feel very comfortable with the targets that we laid out a year ago. But in February, we will give you the specific numbers for 2019.

<**Q - Michael Lasser**>: And my follow-up question is, there has been a lot of well-documented pressure on many of the home improvement vendors, and you've been vocal about seeing an increase in the requests for price increases for those that sell products into you. So putting aside the commodity inflation, are you starting to see an increase in product price inflation associated with the 90% of your sales that are related to product? And do you expect that that's going to continue to increase from here?

<**A - Edward P. Decker**>: We're certainly seeing – we are still seeing cost out, but we are seeing a net cost in that we haven't experienced in the last several years, and we are seeing an increase in supplier requests for cost in. But again, I'd say they're facing some of the same costs that Carol called out. People are facing transportation costs, that's what we hear universally, again outside, as you said, commodity or tariff. Things like transportation is universal. And who knows what happens going into 2019, but that seems to be the theme for the cost requests for 2018.

<**Q - Michael Lasser**>: Just to follow up on that, since you quantify the impact that commodity inflation provides to your ticket, could you quantify the impact that non-commodity inflation provides to your ticket?

<**A - Edward P. Decker**>: What we've seen to date, it's less than ticket, than simply the commodity that we called out, the 61BPS.

<**A - Carol B. Tomé**>: It's less than that.

<**Q - Brian Nagel**>: So I think I want to follow up a bit at the risk of beating a horse here on the macro – if I may follow up to Michael's questions. Carol, when you talk about your algorithm, which the detail you gave so far is very helpful, thank you.

Particularly with regard to the housing turnover metrics, it sounds to me like you're talking more from a coincidence standpoint in how shifts in these metrics impact sales at Home Depot almost in real time. Have you done any work around or any insights into how the lead/lag relationships? If we are seeing this somewhat slower housing turn data now, who knows if that's going to persist or not? But could that have a larger impact upon sales at Home Depot at some point in the future?

<A - Carol B. Tomé>: The correlation coefficients that I shared with you on turnover were based on a one-month lag, and we haven't done a lot of leading/lagging work yet because the environment is still very different than it's been in prior cycles.

There has been a lot of conversation, for example, on affordability, and we look at affordability too. But what happened last time around, when affordability started to, if you will, slow down is the underwriting standards loosened up dramatically, and that's what led to the housing prices, as we all know. That's not going to happen again because of Dodd-Frank. And so you can't look at history necessarily to understand what's going to happen in the future. You've got to look at the future and what's happening. And as we look at the future and what's happening, fundamentally you've got to look at the economy, and the economy is good. People are employed. They have more income. They've got more to come with tax reform. So fundamentally, we feel very good about just the drivers of the spend in our business.

<Q - Brian Nagel>: Got it, and then a follow-up question. There has been a lot of written about and talked about. There are certain markets within the United States where you've seen pronounced weakness in home sales as a result of either supply issues or housing prices, whatever, and I think you've discussed this on prior calls. But as you look at your business, whether those areas are in the Northeast, the West Coast, whatever, are you seeing any – in those type of markets, are you seeing any impact upon Home Depot sales?

<A - Carol B. Tomé>: So we believe, like you, that housing is very local. And when you get into the areas of home price appreciation and affordability, I think it's really local. So we went market by market to see are we seeing any measurable impact on our sales, and we just can't see it.

Now, we're hopefully smart enough to understand that you've got to stay really on top of the data because the one watch-out, of course, is will affordability with rising home prices and rising interest rates at some point set a market clearing price for all home price appreciation and home price appreciation stalls? We're not there. And in fact, home prices are projected to increase next year, but we're watching this.

I'll just give you one example without giving you the numbers because we don't want to get into a habit of calling out performance by market. But if you look at L.A., the affordability index in L.A. is terrible, it's 59. It's the worst it's been since 2008, and our sales in L.A. are very good.

<Q - Charles P. Grom, Jr.>: Just again on the housing front, Realogy spoke last week about a pretty significant slowdown in October, transactions down 6%. And it looks like your October comps were 11.2%, on the stack adjusted for the hurricanes, say, up 12.4%, so a little bit of a slowdown YTD. I'm just wondering. When you look at the month of October, was there anything significant from the volatility or where the customer was buying and how they were buying?

<A - Craig A. Menear>: Overall, again, when you think about what happened in last year's hurricanes, as Carol called out, there was more hurricane pressure that we faced in October than in September. And clearly September and October combined were much more significant from a pressure standpoint than the beginning of the quarter.

<A - Carol B. Tomé>: And even if you ignore hurricanes, there wasn't anything dramatically different in the business other than the volatility in commodity prices. At the end of the quarter, we saw lumber prices fall precipitously. But I think, Ted, that actually was in some ways good news.

<A - Edward P. Decker>: No, that's very good news. If you look at some of the cost pressures we're seeing on the one hand with certain commodities and tariffs, we've seen a dramatic decrease in wood fiber costs, so we went down. At one point the year, we were 40% above the prior year. We're now 24-ish percent below prior year. And as those lumber prices have come down, unit productivity has moved dramatically and we believe kick-starting more project business, which is obviously great for us.

<A - Carol B. Tomé>: And one reason why we really aren't concerned about Q4 from a commodity perspective is because we see this unit productivity.

<Q - Charles P. Grom, Jr.>: Okay, that's very helpful. And then just to switch gears, inventory levels relative to sales, they widened a bit more than the past couple of quarters. I'm curious if that was intentional, as maybe you look to bring in some items ahead of the tariffs, or was it the spillover from October? Maybe just frame out how you feel about currency and where you think you'll end the year on the inventory front.

<A - Edward P. Decker>: From an inventory standpoint, Mark is here. I'll let him speak to this a little bit. We feel good about the overall quality of the inventory that we had, and the growth in inventory is really by design given a few factors.

<A - Mark Holifield>: Yes, we continue to expect to see inventory productivity here at The Home Depot, but customer service begins with in-stock. So we really focus mostly on our in-stock.

We have implemented tiered replenishment strategies that really provide focused investments to drive sales and in-stock where it matters the most, and the results we're seeing from that are really very good. We've actually reduced the number of out-of-stocks per store by 24% in our top-selling SKUs. And Ann's folks bringing that to life with the new in-store processes, we feel great about our shelf availability there. On top of that, we've improved our direct fulfillment center in-stocks and service levels to the customers and setting new records in terms of in-stock there. So we're pleased with our in-stock levels and the investments we've made there.

<A - Edward P. Decker>: The other part of that is, we've pulled forward some merchandising resets, and obviously we've invested in that as well. And then to your point, we did pull some planned purchases forward to get ahead of any potential tariffs.

<Q - Simeon Ari Gutman>: If we add back some of the hurricane impacts that you called out, you get to somewhere in the 5% to 6% range, and I'm keeping inflation in there for now. I just want to know, is that number consistent with markets that have not been affected by any weather that y-over-y there's no benefit or tailwind – or I'm sorry, headwind? And then anything changing with consumers and opening price points, opting for something lower ticket, anything on the consumer side that shows any cracks?

<A - Carol B. Tomé>: We always look at the spread of performance by our 19 U.S. regions. And if you throw out the high and the low because those are hurricane-related, one was negative and one was double-digit positive, if you threw out the high and the low, the spread was the narrowest it's been in a long time. It was 6.8%.

<A - Edward P. Decker>: And on the product purchase, we continue to see both pro and consumers trading up with all the innovation, the great products and brands we're offering in the stores. So that was extremely healthy. And that progression of comp as you go up price points, in fact, if you look at our increase in ticket, of the 3.5%, the vast majority of that is driven by mix and innovation.

<Q - Simeon Ari Gutman>: Right, okay. My follow-up, just two quick parts. The inventory, I guess the extra inventory, can you tell us what categories you're investing deeper in? And then just a point of clarification, this may have been mentioned in the prepared remarks. Q4 EBIT looks a little bit below the Street. Is that freight cost continuing, or is there some shift of expenses that go from third quarter into fourth?

<A - Carol B. Tomé>: I'll try to answer that first. Based on the guidance that we've given you, the expense growth factor in Q4 should be lower than what we reported in Q3, and the gross margin expansion should be higher. That's a bit because of the 53rd week, so maybe there is some issue with the 53-week modeling, I don't know, but we can certainly offline help you with your models.

<Q - Simeon Ari Gutman>: Okay, and the inventory?

<A - Edward P. Decker>: As far as inventory categories, we're not going to get specific about where we invested for competitive reasons.

<Q - Matthew McClintock>: I'd actually like to ask two quick questions. The first one is on car and van delivery, increased utilization for both pro and DIY. Are you seeing outsized gains in either pro or DIY relative to the other as you roll this out and build awareness?

<A - Edward P. Decker>: Car and van, we're pleased with the rollout there. As Craig mentioned, we're up to 41% of the population with car and van available, so we're very pleased with that rollout. As the trucks get bigger, the pros get more engaged. So if you think about it, our big flatbed deliveries, that's very pro-focused. As you work your way down to car, that's more and more consumer-focused. We're pleased to have that option out there for all our customers though. It's an important part of the portfolio of delivery options, and we think those options are important across the range to meet our customers' needs on any given occasion.

<Q - Matthew McClintock>: Thanks, that's helpful. And then as a follow-up, just on home décor, I've seen the catalog this year. Are you leaning into that category in any way different than what you did last year? Is there any build there, or is it more of the same?

<A - Edward P. Decker>: As we outlined in our investor conference at the end of last year, we said we were going to lean into home décor, and we've been doing that with the catalog and online. This is an online and direct play for us, and we're seeing nice results. The customer is engaging with The Home Depot in home related to core categories, and we'll continue that through next year certainly.

<Q - Matthew McClintock>: Can I just on the back end of that, is there anything specific to the holiday that you think about with that category relative to the rest of the year?

<A - Edward P. Decker>: No, we do our holiday décor set in the stores. Obviously, that continues to be an incredibly strong business. In fact, it's the success in that business that gave us confidence that we could move a little more décor-oriented, not product we'd want to bring into the store, but perfectly appropriate to engage the customer online.

<Q - Steven Forbes>: I wanted to start with the expense growth factor, if you can. Can you help us break down the components in Q3? I think accounting, strategic investments, business as usual. And then as part of that, maybe just update us with your thoughts on the appropriate business as usual run rate given the YTD performance. Is it still that 90% at 4.5% comp and 75% at 6%? It looks like you're doing a little better than that YTD.

<A - Carol B. Tomé>: I think what I'll do for you is break down the components for the full year because I've given you the dollars for the quarter, and you can do the math. We're guiding an expense growth forecast of 131% for the full year. The breakdown of that is BAU is 42%, invest is 51%, and the change in accounting is 38%. And then in terms of the longer-term view of our guidance, nothing has materially changed.

<Q - Steven Forbes>: And then just a quick follow-up, given the build-out plans within the supply chain, maybe just update us what your view is around hiring and retaining employees, given the competitive workforce dynamic and obviously your initiatives on that front. Are you having trouble, or are you still finding the availability of employees to meet that upcoming need, the future need?

<A - Edward P. Decker>: We were able to hire over 80,000 associates for our spring selling season this year. Candidly, we had a little concern as to whether or not it would be more challenging, but we really didn't find that to be the case. And, Mark, I don't think you've seen anything different right now on supply chain.

<A - Mark Holifield>: No, it's been pretty much the same there. We've had no real issues there.

<Q - Seth I. Sigman>: A couple follow-up questions. Just to go back to housing, as you mentioned, the consumer is obviously very healthy right now. On the housing front, there's a lot of talk about just the lack of urgency as it relates to turnover, not actual demand, but there's a lack of urgency. And I realize turnover on its own is a small part of the business, but I'm curious. From a behavioral perspective, like are you seeing any signs that the consumer is maybe taking more of a wait-and-see approach as it relates to bigger projects, similar to how they're approaching purchasing a home?

<A - Carol B. Tomé>: We're not seeing that, and Ted called out the strength in our big ticket categories, which grew more than 9% in the quarter. One hypothesis is that with rising interest rates, consumers are incented to stay in their home, and they have wealth in their home and their home is aging, and so they're spending money on their home.

The other thing I would like to say about the consumer, because we've done a lot of work in this regard and just thought we'd share it, because there was some interest about what does the impact of tax reform really mean on consumers' wallets, and I think we all know that tax reform is really good for consumers. It's projected that $1.1 trillion will flow to consumer tax filers over the next 10 years.

The way that's playing out in 2018 is about 43% of that benefit is flowing into paychecks today. The remaining 57% of the benefit will be realized when filers actually file their tax return next year, and they'll claim credits and that's how they get their benefits. The only way they could receive that benefit today is if they have adjusted their withholding. So we looked at 300,000 Home Depot associates to see whether or not they had adjusted their withholding, and only 3,000 of those associates had adjusted their withholdings. So we believe that many consumers are going to have a nice tax surprise next year.

Now, if you're a high earner in a high state and local tax state like California or New York or Connecticut, that won't be the case, but high earners are actually those with $500,000 or more. Those folks, they're going to have a bit of tax bill. And if they haven't prepared for it, it's going to be a negative surprise. But we went to our consumer insights team and said hey, what's the average income of our customers? 97% of our customers' average income is less than $250,000. So we think the health of the consumer continues into 2019.

<Q - Scot Ciccarelli>: So are there any markets or even product categories where you're starting to see some trade-down activity? And related to that, how do you think that would play out in a rising price environment because of tariffs and maybe you grant some of the price increase requests that you're getting from your vendors?

<A - Craig A. Menear>: So I'll start with the comment and turn it to Ted. Even in the downturn of 2008, which was obviously the most difficult since the Depression, customers were willing to spend for new innovative product.

<A - Edward P. Decker>: Scot, we haven't seen it yet. It's something I'm looking at very closely. We're looking at unit productivity by opening price point, good-better-best-premium, making sure we're priced right at the opening price point level and making sure inventory levels are ready to go to see if we're going to – to see that dynamic that you just referenced, and we have not seen it. Now whether that comes, we'll be ready for it. but to date, as Craig said, people are trading up to the new innovative product.

<A - Craig A. Menear>: The classic example of that is you take a category like vinyl flooring. Vinyl flooring was almost on its deathbed. Then innovation came along, and you now have vinyl plank flooring that is flying off the stores at a premium price. It's a great value to the customer. It's easy to use. It's simple for the pro to install, and that's a classic example of why innovation drives sales.

<Q - Scot Ciccarelli>: And to be clear on the market front, Carol, you already mentioned the L.A. market, for example. Any markets where you're starting to see trade-down activity, maybe particularly if you could focus on any kind of overheated housing markets, so what you would view as where affordability isn't great?

<A - Craig A. Menear>: I haven't seen anything like that at all.

<A - Carol B. Tomé>: I haven't seen it.

<Q - Elizabeth L. Suzuki>: Can you give any additional detail on the performance in Canada on a constant currency basis? I think you guys mentioned that the comps were positive, just curious how strong it was there.

<A - Craig A. Menear>: Canada posted positive comps in local currency. Clearly, there are pressures in Canada from a housing standpoint. The government has made a conscious decision to slow down housing in Canada. And you see that in the numbers, but they delivered a great performance. We are seeing terrific online growth in Canada as the Canadian customer embraces e-commerce as well.

<Q - Elizabeth L. Suzuki>: Great. And was there any impact in the quarter from competitive pricing from other large players as they rationalize some inventory this quarter?

<A - Craig A. Menear>: We've certainly seen much more promotional activity as folks have made decisions to close stores and liquidate inventory.

<Q - Elizabeth L. Suzuki>: Okay. Would you say that had a material impact on your sales this quarter, or was it not enough to call out?

<A - Craig A. Menear>: We don't...

<A - Carol B. Tomé>: We don't know how to measure that.

<A - Craig A. Menear>: We don't have a clue of how to measure that.

<Q - Jonathan Matuszewski>: Just to start off, last quarter you mentioned some cross-functional teams focused on improving the experience online for customers, so maybe just expand on that. What do you see as your competitive advantage today online relative to peers? And with personalization a big push, have you seen a benefit in terms of average order values or transactions when the site is customized based on prior purchases?

<A - Edward P. Decker>: Overall, absolutely we're very pleased with the results from our initiatives as part of our investment strategy that we laid out. Supply chain is obviously a very big component of that, but leaning into our online investments is also a large piece of that. And we've started to do a lot of work with our category refreshes. So think of this as a virtual reset online, a lot of work on our search efficacy, a lot of work with the supply chain team as they've gotten sharper on delivery in our delivery windows. We call it dynamic ETA. So when you're checking out, we would put before a broad brush 7 to 10 days for delivery. Now by ZIP Code, we can put the day that you'll be getting that product.

All of these things have led to much better traffic. We had one of our strongest traffic quarters that we've seen in a number of years. Our visits were – our absolute increase in visits was our single largest growth in a quarter in visits. And then it all resulted in the comp sales of 28%, and that's also due to increased conversion. So we're getting people to engage into the site. The experience is getting to the right product. We're getting to the right close. All of this while more and more of the traffic moves to our mobile app and mobile devices and we're seeing double-digit increases in conversion rates and modest increase in average ticket. So we're very pleased with all the initiatives.

<A - Craig A. Menear>: And clearly the customer is engaging obviously in the digital world, but 48% of the orders in the quarter were picked up in store at the customer's choice. So this is truly an interconnected experience going forward, leveraging all of the capabilities and assets of The Home Depot in both the digital and physical world.

<Q - Jonathan Matuszewski>: Great, that's helpful, and then just a quick follow-up. Can you give an update on the store labor pilot? I believe you pointed to a sales lift in Q2 from the pilot, maybe better conversion and whatnot. So maybe just discuss any potential uplift in sales from Q3 from the labor pilot and what's the trajectory for rolling that out ahead? Thanks.

<A - Carol B. Tomé>: It is easier for us to quantify the productivity that we enjoyed off of the new labor model, which Ann-Marie has put into our stores. We saw 46BPS of payroll leverage in Q3, and a large part because of that new labor model.

<A - Ann-Marie Campbell>: We are fully rolled out across the company, so we will get the full benefit in 2019.

<Q - Scott A. Mushkin>: I just wanted to ask Carol, if you look at the business, obviously we had a very sharp housing downturn in 2008. But if we look at the business, let's just assume we get a downturn because almost every investor seems to think. How do you think the business performs through an average downturn? Have you guys looked at that? And then also, would you guys ever consider using your balance sheet more aggressively as we got into a situation like that? So that's my first question.

<A - Carol B. Tomé>: So what we've done is look through the last recession, which was just a crazy recession and went back to the 2000 timeframe, where the country was in a fairly mild recession and our comps at that point were flat. So we modeled flat comps to say that's a reasonable downturn. I don't know if it's reasonable, but I think it's reasonable. Staying true to our investment plan, because of the financial strength of the company, we can stay true to our investment plan, and we take our operating margin down to a little over 12%.

<Q - Scott A. Mushkin>: I'm sorry, could you say that again? You just cut out a little bit.

<A - Carol B. Tomé>: I'm sorry, we'll take our operating margin down to a little over 12% in a flat comp environment, staying true to the investments. And we believe scale is a competitive advantage. We use it every day. As Ted mentioned, we have lots of people come knocking on our doors asking for things, and we're working through that with the power of The Home Depot.

<Q - Scott A. Mushkin>: And then as far as using the balance sheet a little bit more aggressively if we've gotten to that downturn situation?

<A - Carol B. Tomé>: That's our scale. We have the opportunity to do that, yeah