Company Name: Home Depot
Company Ticker: HD US
Date: 2017-02-21
Event Description: Q4 2016 Earnings Call

Market Cap: 178,719.36
Current PX: 151.609
YTD Change($): +17.529
YTD Change(%): +13.074

Bloomberg Estimates - EPS
Current Quarter: 1.805
Current Year: 7.312
Bloomberg Estimates - Sales
Current Quarter: 24402.409
Current Year: 99751.346

Q4 2016 Earnings Call

Company Participants

- Diane Dayhoff
- Craig A. Menear
- Edward P. Decker
- Carol B. Tomé
- Mark Holifield
- Bill Lennie

Other Participants

- Simeon Ari Gutman
- Seth I. Sigman
- Christopher Michael Horvers
- Michael Louis Lasser
- Cody T. Ross
- Daniel Thomas Binder
- Dennis Patrick McGill
- Matthew J. Fassler
- Seth M. Basham

MANAGEMENT DISCUSSION SECTION

Diane Dayhoff

Non-GAAP Financial Measures

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

Reconciliation of these measures is provided on our website

Craig A. Menear

Business Highlights

Comp Sales and Diluted EPS

- FY2016 was a record year for our business, as we achieved the highest sales and net earnings in company history
- FY2016 sales grew $6.1B to $94.6B, an increase of 6.9% from FY2015, while diluted EPS grew 18.1% to $6.45
- Sales for Q4 were $22.2B, up 5.8% from last year
- Comp sales were up 5.8% from last year, and our U.S. stores had positive comps of 6.3%
- Diluted EPS were $1.44 in Q4

Store and Geographies

- We continue to see broad-based growth across the store and our geographies
- All three of our U.S. divisions posted positive comps in Q4, as did all 19 U.S. regions and top 40 markets
- Internationally, both our Mexican and Canadian businesses posted positive comps in local currency for the quarter, making it 53 and 21 quarters in a row of positive comps, respectively

Merchants and Store Teams

- Our merchants and store teams did an outstanding job delivering value and service for our customers across multiple events throughout the quarter, both in stores and online
- As Ted will detail, both ticket and transactions grew in the quarter, and all of our merchandising departments posted positive comps

Pro and DIY Categories

- We saw healthy balance of growth among both our Pro and DIY categories, with Pro sales outpacing DIY sales in the quarter
- A portion of our overall Pro strategy is focused on the integration of the underlying business, which continues to progress
- We are pleased with the traction that we are seeing, as we have successfully completed work on the first business use case

Interline's Customers

- The roll-out of Interline's catalog of products is now taking place across all U.S. Home Depot stores
- The next phase of the integration is focused on enabling Interline's customers to use their Interline accounts for purchases in Home Depot stores or on homedepot.com
- We're excited about the opportunity Interline provides us to expand our share of wallet with Pro customers

Interconnected Business

- Our interconnected business made great strides in 2016
- The team substantially completed the HD.com redesign with enhanced features for better search and faster checkout, upgraded the mobile app, and introduced a dynamic estimated time of arrival feature to provide customers a faster and more accurate delivery date based on location
  - We measure the success of these changes by the increased traffic and conversion rates that we have seen across our interconnected platforms, as well as improved customer service scores

Online Business

- For the year, our online business grew over 19% vs. the prior year, and now represents 5.9% of our total sales
- While we are seeing significant growth in our online business, our stores have never been more relevant, as about 45% of our online U.S. orders are picked up in our stores, a testament to the power of our interconnected retail

strategy

- As you know, our interconnected business is much more than our online properties, as it seeks to blend the physical and digital world seamlessly to enable customers to shop with us whenever and however they choose
  - A key component of this strategy has been the investments that we've made to meet customers' demands for increased fulfillment options

BODFS

- This quarter, we completed the roll-out of BODFS, or Buy Online Deliver From Store
- BODFS was built on the foundation of our new Customer Order Management system, or COM, which was fully deployed in all U.S. stores during Q2 2016
- We're pleased with the positive customer response to this enhanced delivery option, which streamlines the delivery experience for both our customers and our store associates
- Our customer demands are changing, which means we must continue to simplify operations for our store associates

Freight-Handling Initiatives

- Our efforts to improve our freight-handling initiatives by connecting end-to-end are focused on creating one consistent process for every store that drives efficiency, removes waste, and optimizes product flow from truck to shelf
- This quarter, we completed the roll-out of manual flow load for trucks from our RDCs to stores, which is a documented process for better utilization or cube-out of trucks en route to our stores
  - This process is standardized across all stores and has the benefits of reducing transportation costs by fully utilizing the capacity of each store-bound truck, as well as improving freight movement at the back of our stores as products are staged more efficiently for store associates

GDP Growth

- Turning to 2017, overall GDP growth and the strength in the U.S. housing market should continue to support growth in our business
- As Carol will detail, we expect 2017 comp sales of approximately 4.6% and diluted EPS of $7.13

Dividend and Share Repurchase Program

- It was announced today that our board approved an increase in our targeted dividend payout ratio from 50% to 55%, and a 29% increase in our quarterly dividend to $0.89 per share, which equates to $3.56 annually
- The board also authorized a new share repurchase program of $15B
- We remain committed to a disciplined capital allocation strategy to create value for our shareholders
- We will invest to sustain and grow our business and return value to our shareholders through dividends and share repurchases

Sales, Projects, Acquisition and Supply Chain Initiatives

- Over the past two years, we grew our sales by over $11B
- This was accomplished during a time when introduced a great deal of change into the business, not just in the U.S., but in Canada and Mexico as well
- Projects like COM and BODFS, the acquisition of Interline, and our supply chain initiatives challenged our associates to adapt and learn to do old things in new ways
  - Our orange-blooded associates repeatedly rise to meet these new challenges head on, demonstrating the entrepreneurial spirit and passion for our customers that has made The Home Depot what it is today

Closing Remarks

I want to close by thanking these associates for their hard work and dedication to our customers in Q4 and throughout the year

For H2, 98% of our stores qualified for Success Sharing, our profit-sharing program for our hourly associates

We look forward to continuing this momentum in 2017

Edward P. Decker

Q4 Highlights

Sales Growth

- We had a strong fourth quarter, as sales exceeded our expectations
- We saw strength across the store, led by our Pro customer, and our online business continued its double-digit growth, with sales growth of approximately 19% in Q4
- All of our merchandising departments posted positive comps, led by Flooring and Tools, which had double-digit comps in the quarter
- Lumber, Outdoor Garden, Appliances, Decor, Indoor Garden, Lighting and Plumbing were above the company’s average comp
- Hardware, Millwork, Electrical, Kitchen-Bath, Building Materials and Paint were all positive, but below the company average
- We continue to see balanced growth between transactions and average ticket in the quarter
- Total comp transactions increased 2.8%, while comp average ticket grew by 2.9%

Commodity Price Inflation and Foreign Currency

- Our average ticket increase was slightly impacted by commodity price inflation and foreign currency
- Commodity price inflation positively impacted ticket growth by approximately 32BPS, while a weaker Mexican peso negatively impacted ticket growth by approximately 45BPS

Big Ticket Sales

- Looking at big ticket sales in Q4, transactions over $900, which represent approximately 20% of our U.S. sales, were up 11.6%
- The drivers behind the increase in big ticket purchases were:
  - Flooring
  - Appliances
  - And several Pro categories

Pro Heavy Categories and DIY Customer

- Once again, Pro sales grew faster than the company comp
- We saw strong comps in Pro heavy categories like:
  - Fencing
  - Pressure-Treated Decking
  - Commercial and Industrial Lighting
  - Electrical Wiring
  - And Interior Doors
- We also saw strength with our DIY customer, classes that outperformed included:
  - Special Order Carpet
  - Outdoor Power
  - Laminate Flooring
  - And Storage

Black Friday, Gift Center and Holiday Programs

- We drove record sales in each of our Black Friday, gift center and holiday programs
- Our customers responded to our great values since traffic increased inside our stores and online, and we recorded our highest Cyber Week ever
- Our events helped drive robust comps in:
  - Decorative Holiday
  - Tool Storage
  - Power Tools
  - And Appliances

Outdoor Garden Category

- As part of our focus on balancing the art and science of retail, we continue to refine and localize our assortments

- In our Outdoor Garden category, we are leveraging the power and agility of our local garden merchants
  - These merchants work directly with our stores and local growers to ensure we have the right mix of products to meet the demands of each individual community
  - As an example, during the drought in the West, our merchants sourced the highest-quality drought resistant live goods
  - As we look for to this spring, our local merchants are adjusting the assortment to meet current demand given much weather conditions
  - As customer preference continues to evolve and change, we will have local customized assortments so that the right product is always available

Q1

Product Authority

- Now let's turn our attention to Q1
- We are committed to being the product authority for home improvement
- Product authority means having the best brands at great everyday values for our customers
- With this, we are excited to introduce Milwaukee's new lineup of cordless outdoor power equipment
  - This lineup will include a string trimmer, blower, and hedge trimmer that are all part of the M18 platform of 125-plus tools
  - These professional-grade products have 18-volt power, a brushless motor, and come with a 9-amp power battery that delivers unmatched power and run time
  - These Milwaukee products are a Big Box exclusive

New Patio Mix & Match Offering

- With spring rapidly approaching, we're gearing up for warmer weather in the outdoor project season
- We are very excited about our new Patio Mix & Match offering where our customers are now able to fully customize their own patio set by mixing and matching different table, chair, cushion, and umbrella combinations to create their very own personalized set
- We've seen a fantastic response from our customers with double-digit comps in the category

Spring Black Friday

- Our Spring Black Friday is also right around the corner, and we are excited for another successful event
- To help our customers kick off the spring season right, we will be offering special buys on springtime products such as grills, outdoor power equipment, and live goods
- We're looking forward to a great spring season

Carol B. Tomé

Financial Highlights

Sales

- In Q4, sales were $22.2B, a 5.8% increase from last year. vs. last year, foreign currency rates, primarily a weaker Mexican peso, negatively impacted total sales growth by approximately $96mm or 0.5%
- Our total company comps, or same-store sales, were positive 5.8% for the quarter with positive comps of 5.7% in November, 7.1% in December and 4.7% in January
- Comps for U.S. stores were positive 6.3% for the quarter, with positive comps of 6% in November, 8% in December and 5.1% in January
- For FY2016, our sales increased 6.9% to $94.6B and total company comp sales were positive 5.6%
- Comps for U.S. stores were positive 6.2%
- During the year, a stronger U.S. dollar negatively impacted sales growth by approximately $549mm, or 0.6%

Gross Margin

- Our total company gross margin was 34% for the quarter, a decrease of 10BPS from last year
- The change in our gross margin is explained largely by the following factors:
  - First, we had 8BPS of gross margin expansion in our supply chain, driven primarily by increased productivity
  - Second, we had 15BPS of gross margin contraction due to higher shrink than one year ago
  - And finally, we had approximately 3BPS of gross margin contraction, due mainly to a change in the mix of products sold
- For the year, we experienced 3BPS of gross margin contraction

Operating Expense and Margin

- In Q4, operating expense as a percent of sales decreased by 113BPS to 20.8%
- Our expense leverage was driven principally by our strong sales performance and good expense control
- Our total company expenses were $11mm higher than planned due to expenses associated with our 2014 payment data breach
  - With this, we now believe the majority of expenses associated with our payment data breach are behind us
- FY2016 operating expense as a percent of sales was 20%, a decrease of 92BPS from what we reported last year
- For the year, our expenses grew at 30% of our sales growth rates
- Our operating margin for the quarter was 13.2% and for the year was 14.2%

Tax Rate and EPS

- Reflecting favorable tax reserve adjustments, in Q4, our effective tax rate was 35.2% and for the year, our effective tax rate was 36.3%
- Our diluted EPS for Q4 were $1.44, an increase of 23.1% from last year

- For the year, diluted EPS were $6.45, an increase of 18.1% compared to FY2015

New Stores Opening and Merchandise Inventories

- Now moving to some additional highlights, during the FY, we opened four new stores in Mexico, bringing our total store count to 2,278 and selling square footage to 237mm square feet
- For the year, total sales per square foot increased 5.5% to $391, our highest sales per square foot since 2001
- At the end of the quarter, merchandise inventories were $12.5B, up $740mm from last year, and inventory turns were 4.9 times, flat with last year

Capital Allocation

- Moving on to capital allocation, in FY2016, we generated approximately $9.8B of cash from operations and used that cash, as well as proceeds from $2B of incremental long-term debt issuances, to invest in the business, repurchase our shares, and pay dividends to our shareholders
- During the year, we invested approximately $1.62B back into the business through CapEx

Share Repurchase, Dividends and ROIC

- Further, we repurchased approximately $7B, or about 53mm of our outstanding shares, including roughly $2.4B or 18mm shares in Q4
- And finally, during the year, we paid $3.4B in dividends to our shareholders
- Computed on the average of beginning and ending long-term debt and equity for the trailing 12 months, return on invested capital was 31.4%, 330BPS higher than at the end of FY2015

Guidance

Now looking ahead, this morning we issued a press release with our guidance for FY2017

And I want to take a few moments to comment on the highlights

Remember that we guide off of GAAP, so our FY2017 guidance will launch from our reported results for FY2016

As we look to 2017, we remain encouraged by the strength of our core business and by what we are seeing in the housing environment

While private fixed residential investment as a percentage of GDP now stands at 3.8%, it has a way to go before it reaches the historical mean of 4.5%

Home price appreciation, housing turnover, and household formation continue to be tailwinds for our business

Sales

- Using our directionally-correct but imperfect sales forecasting model, we are planning for FY2017 sales to grow by approximately 4.6%
- Sales growth at Interline and the opening of six new stores in 2017 will not materially change our overall growth rate
- So our 2017 comp sales guidance is the same as our overall sales growth guidance

- Now one last comment on our sales growth guidance
- It is based on 2016 average U.S. dollar foreign exchange rates
  - If exchange rates remain where they are today, there is about $230mm of sales pressure to the guidance

Gross Margin and Expense

- For FY2017, we are projecting our gross margin rate to decline by approximately 15BPS from 2016, as we are planning for outpaced growth in lower-margin categories, such as Appliances and certain building material categories
- On the expense front, we are forecasting our expenses to grow at approximately 49% of the rate of our sales growth, in line with the long-term guidance we provided to you in 2015

Operating Margin and Tax Rate

- For the year, we expect that our operating margin will grow by approximately 30BPS to 14.5%, reaching our FY2018 target one year in advance of our goal
- We will update our FY2018 operating margin target at our Investor Conference scheduled for later in the year
- For the year, we expect our effective tax rate to be approximately 36.3%
- Starting with FY2017, we are adopting FASB Accounting Standards Update 2016-09 for employee share-based compensation
  - Note that the estimated positive impact of this new accounting standard is reflected in our projected tax rate, but the actual impact won't be fully understood until equity grants are exercised throughout the year

Diluted EPS

- We expect our FY2017 diluted EPS to grow approximately 10.5% to $7.13
- Now as Craig mentioned in his remarks, in support of our commitment to return value to shareholders, our board just announced a new share repurchase authorization of $15B, replacing our existing authorization
- Our EPS guidance includes our plan to replace approximately $5B of outstanding shares during the year using excess cash

Cash Flow, Capital Spending and Share Repurchases

- For the year, we project cash flow from the business of roughly $11.3B
- Our 2017 capital spending plan is approximately $2B
- We will use this capital to support our strategic initiatives and invest in our aging store base to improve the customer experience
- In addition to capital spending and share repurchases, we will use our cash to pay $4.2B in dividends to our shareholders

Dividends

- As Craig mentioned, our board just announced an increase in our targeted dividend payout ratio from what was 50% to now 55%
- With that, we announced a 29% increase on our quarterly dividend, which equates to an annual dividend of $3.56
- Our disciplined approach to capital allocation continues to be evidenced by the investments we are making in our business and the cash return to shareholders

QUESTION AND ANSWER SECTION

<Q - Simeon Ari Gutman>: My first question is on the – I guess, the balance between the same-store sales guidance and the gross margin guidance. How should we think about market share gains in that 4.6% vs. the mix of product and/or, I don't know if it's promotion, but just maybe mix of product and maybe being more aggressive in the Appliance area?

<A - Craig A. Menear>: Yeah, so I'll start, and I'll let Carol comment. When you look at the projected margin, as we've said, we're intending to lean into growth in categories that are lower-margin rate categories like Appliances, but also as our Pro business continues to grow with categories in Building Materials. And so that's really what we're looking at as it relates to the gross margin. And if you think about the last two years, gross margin has roughly been about 3BPS. With the 15BPS next year, that's about a 12 basis point decline, and we kind of consider that to be pretty flat.

<A - Carol B. Tomé>: And maybe I'll just add a little color about our sales forecasting model. As you know, it starts with GDP growth forecasts, and for the U.S., GDP is projected to grow by 2.3% in 2017. We then add to that the benefits we believe we will get from rising home prices, housing turnover, and household formation. And we think housing will add another point-and-a-half growth to our overall growth next year.

To that, we have added a little bit of share shift in Appliances and certain building categories. And just to put that in perspective, in 2016, Appliances contributed 50BPS of our comp growth. So that gives you a sense of the share that we're including in our guidance.

And then we're adding something else this year that we haven't included in the past, and that's what we call the cumulative wealth effect of home price appreciation. If you look at home equity, since 2011, home equity is up 108%. On average, that equates to $50,000 per household. And we believe that's contributing – as people use the equity of their house to spend back into their house, we believe that's contributing to our growth, so we factor that into our guidance, and that's how we got to the 4.6%.

<Q - Simeon Ari Gutman>: Got it. Okay. That's helpful. My follow-up, on SG&A, I think the guidance suggests that the dollars grow I guess 49% relative to sales, and of course, Home Depot has had a strong bias to do better than its expense guidance over the years. As you look – as we look out to next year, is there anything in the mix that would prohibit or prevent you from maybe upside, is there anything more structural about the complexion of SG&A next year?

<A - Carol B. Tomé>: So let me walk you through how we got to our guidance for 2017. As we commented, in 2016, our expenses grew at 30% of our sales growth rate. A bit of that was distorted because of payment data breach expenses that were incurred in 2015 and did not repeat in 2016. So if you ignore the payment data breach, our expenses in 2016 grew at about 38% – call it, 40% of our sales growth rate.

It's stepping up to 50% in 2017 for a few reasons. We, like many companies, are facing rising wages, as well as higher medical costs, and we have factored that into our guidance. It doesn't mean that we won't drive productivity to offset some of that pressure like we have historically, but we have factored that into our guidance. Further, we're seeing some cost pressure coming in from property taxes in certain states like California, so we factored that into our guidance. And finally, because our capital spending is stepping up slightly year on year, there's a bit of expense associated with that. But as you know, productivity is a virtuous cycle at The Home Depot, so we always try to do better.

<Q - Seth I. Sigman>: My first question is about Interline. I may have missed it, but what are you assuming for growth of that channel? And as you think about the integration, it sounds like the initial roll-out of the catalog, that's gone well in the early testing. Can you give us a sense of what you've seen; maybe a lift or just the change in behavior as you've added that catalog to the store? Thank you.

<A - Carol B. Tomé>: Well, I'll start with the growth assumptions and then we can talk about the performance. On the growth assumptions, we are assuming that Interline will grow faster than the company average in 2017, which was true in Q4 as well. But remember, Interline is less than 2% of our total sales. So it just rounds out at the end of the day, and that's why our comp sales guidance is the same as our total sales guidance for 2017.

<A - Craig A. Menear>: And we are – we're excited about the opportunities with Interline. It is $50B market opportunity across multi-family, hospitality and institutional, which we own about 5%, give or take, of that market. So it's a significant opportunity for us to continue our share of wallet with our Pro customer. And as you called out, we talked about the first use case is allowing our stores to purchase the Interline product. The next thing we're working on is allowing our Interline customers to be able to buy product through Home Depot or homedepot.com on their account. And that we're focused on here in 2017.

<Q - Seth I. Sigman>: Okay. And I guess as a follow-up, you've discussed PFRI a lot over the years and the importance for your business. PFRI, it decelerated quite a bit in 2016, particularly towards the back half in y-over-y terms. Obviously, that disconnects with Home Depot's performance which accelerated. Do you think that's market share, maybe tying in one of the earlier questions, or do you think the mix of the business is changing in a way that's just – perhaps the underlying drivers of your business are changing a bit, too?

<A - Carol B. Tomé>: I think PFRI is a great indicator of the health of the overall market. And as you can see, it is a healthy market. We are a big part of it, aren't we? Because improvements – if you look at the components of PFRI, improvements is one of the big components and we're part of improvements. So in a way, it's a bit circular. I'm not sure that it's a great predictive tool, but it certainly is a great indicator of the health.

Now, here's a really fun fact – and I know you know this because you've done all the research in this area. If PFRI were to return to the mean of 4.5% and GDP remain the same, we'd have to grow about 18.5%. And assuming there's no share shift for The Home Depot, that's $16B opportunity for us. So will we get all those sales? I don't know, but it certainly suggests as the housing market continues to recover, there's growth ahead for The Home Depot.

<Q - Christopher Michael Horvers>: Question, on the cadence in the year, how are we thinking about comps? You just blew through what was supposed to be a very difficult comparison and didn't have any impact at all. How are you thinking about the spring set-up this year and then the overall cadence comps?

<A - Carol B. Tomé>: Well, as you know, we like to look at our business from a half and not a quarter because of what we call the bathtub effect. You're never really sure when spring will land. If we look at the split by half, we would expect H1 to be slightly lower than the back-half of the year.

As you know, we're up against a tough comparison in Q1, particularly the month of February, where last year we had a U.S. comp of 11.8%. I will tell you, Chris, we planned for a positive comp in February. We are beating our plan. It's early in the quarter, of course, but we're feeling very good about our business.

<Q - Christopher Michael Horvers>: That's excellent. On the gross margin, does the outlook reflect any, I guess, slowing supply chain benefits or other pressures like ocean freight? And then related to that, inventories were flat in 2016. Should we see the expansion in 2017 with Project Sync?

<A - Craig A. Menear>: So on the gross margin, we certainly are seeing some pressure from fuel y-over-y, and Mark Holifield is here, can comment, but certainly, we expect to see some of that pressure in the year. But we will continue to get productivity through our supply chain, and then we'll invest that back into the business.

<A - Mark Holifield>: Yeah, Craig, it's Mark Holifield here. On fuel, yes, fuel does look like it's firming up. We use the Department of Energy to base our plans. The forecast there is $2.72 against what it was in 2016, $2.31. And right now, we're at about $2.58. But that's incorporated in our guidance.

In terms of the Sync and continued benefit, we do see continued benefit coming from that as we continue to synchronize the activities between our vendors, our carriers, our distribution centers, and our stores. We are looking into a firming transportation market a bit, but we do expect that we'll be able to offset those things with the benefits that we get from our initiatives.

<A - Carol B. Tomé>: On the working capital front, we expect working capital to be a source of cash for the business in 2017, and we're planning for inventory turns to improve two-tenths year-on-year.

<Q - Michael Louis Lasser>: Carol, can you describe the thought process behind recalibrating the model that you use to predict your sales outlook for the year by adding a component based on the wealth effect? Some of the skeptics might argue that anytime you have to recalibrate your model this far into a cycle, that might be a sign of the top, especially when perhaps one could argue you're double-counting the housing impact because you do have a housing component already and then if you add another, that [ph] weights (36:15) pricing.

<A - Carol B. Tomé>: Well, first of all, I will say it's a minor change; about four-tenths of growth year-on-year. Secondly, our forecasting model is directionally correct, but at the beginning of 2016, it certainly didn't predict a 6.2% comp in the United States. So we use all these factors to build a model to give us a sense of where we're going.

There's another factor out there that we look at, but we haven't incorporated, but we're spending more time trying to understand, and that's the leading indicator of remodeling activity that's published by the Harvard Joint Center for Housing Studies. If you look at that, and I'm sure you have, you can see that it's suggesting growth rates higher than the guidance that we've provided. So no matter how we look at it, we're very confident with the sales forecast that we've given.

<Q - Michael Louis Lasser>: That's helpful. And my other question is on your gross margin outlook for the upcoming year, and really your promotional posture. It seems like you're leaning in and taking advantage of some of the market share opportunities that are going to be afforded to you, but how do you balance between suppressing the profitability of the category and gaining your fair share? So you could lead in, be a little more aggressive on some of the promotions, but if that's what the customer is now conditioned to expect, you may never be able to get that profitability back, even if you did pick up some market share in the process.

<A - Craig A. Menear>: I think it's important to understand that the margin forecast that we're projecting is really much more around the mix of our business and what's growing in the mix of our business. Ted's here. He can comment. We're not looking to drive additional promotional activity, per se. This is all about, we continue to see categories like Appliances gain traction in the market. We continue to see our Pro customer engage in bigger projects and remodeling. Those carry lower rate businesses, but drive higher gross margin dollars, which is why we get the productivity on the operating margin line.

<A - Edward P. Decker>: Yeah, Michael. This is Ted. I wouldn't say our share gains are coming on the back of promotional productivity. Appliances is certainly one category that is promotional, and we do participate in those promotions and have happily taken a lot of share. But the balance of the business, we have been very focused on everyday low pricing and bringing everyday low prices. As you know, we have a very strong Pro business, and you need to be priced right every day when the Pro comes into the store. So the market share gains are happening across the building, and that's the balance that we appreciate the most about it. And other than Appliances, we have not been leaning into promotions, albeit the marketplace in general has been a bit more promotional, that gives us more confidence to support our everyday low price positioning.

<A - Carol B. Tomé>: One other data point, if I may. If you look at sales by category, peak to trough, while we've more than fully recovered everything we lost during the downturn, we haven't recovered every category. We still have $1.4B of sales that haven't fully recovered, and those are in low-margin categories. We want that to grow, and if housing continues to grow, it will.

<Q - Cody T. Ross>: Your Pro business continues to deliver exceptional performance. What is driving that performance? And can you update us on some of the initiatives you're running?

<A - Craig A. Menear>: I mean, Bill and Ted can comment on the Pro business.

<A - Bill Lennie>: Well, we're – this is Bill Lennie. Just a comment on Pro activity. We're seeing a great balance between our low-spend and our high-spend Pro. Good health in the business being driven both by transactions, more transactions, and ticket. So it just says that we've got great activity in the stores. And, as Ted said, the drivers for the Pro are just in-stock and everyday value on the shelf. So it's just health across the business, across multiple categories.

<A - Edward P. Decker>: Yeah, I...

<Q - Cody T. Ross>: Great. [ph] Yeah, let's (40:59) – continue.

<A - Edward P. Decker>: Sure. This is Ted. The other thing that we continue to focus on is certainly being in-stock and having great value every day. We also strive to have the brands that the Pros want and the innovative product that we seek to deliver. And this happens throughout the store. For example, we're launching an even lighter drywall this quarter. It's 25% lighter, which helps the Pro complete their jobs and saves them time, and certainly a lot of backache. The Milwaukee outdoor power equipment, this is Pro runtime and power without the need of, obviously, messy fuels. So a lot of this is product and value that our merchants strive to bring every day for the Pro customer.

<Q - Cody T. Ross>: Great. Thank you. And many believe there's a lot of significant pent-up demand out there that will drive growth in housing in 2017 as you guys alluded to as well. However, rates are expected to rise. Is there a rate that you guys beginning to get worried? And how do you balance that pent-up demand vs. the expected increase in rates? Thank you.

<A - Carol B. Tomé>: Yeah, our analysis would show that for every 25-basis point increase in mortgage rates, it costs the homeowner who's applied for a mortgage $40 more per month. So that helps sort of dimensionalize the pressure associated with rising rates. With the median home price in the country of $250,000, mortgage rates could go up to 7-ish percent before the Affordability Index would fall at 100 or below. [ph] So there's (42:45) a way to go before we'd be concerned. And you know what, mortgage rates stand today at 4.2%, 4.3%, something like that, the historical mean is 5.8%. So even if a return to the mean, you're still below that inflection point.

<Q - Daniel Thomas Binder>: Just sticking with the Pro for a minute, I know you've highlighted product, value, credit, delivery. I'm just curious when you listen to the Pro, how much of the advantage do you have really lies with the store base, the density of the store base, the convenience of the store base in the markets?

<A - Craig A. Menear>: I mean, there's Pro business across all markets. We actually look at the penetration of our Pro business on a store-by-store basis. And this isn't tied to a specific market. It's a broad-based approach that we've taken in the business candidly from the very beginning of Home Depot.

<A - Carol B. Tomé>: We joke, we are Pro.

<Q - Daniel Thomas Binder>: And then in a quarter, I hate to even bring it up, but the shrinks was up a bit. I was just curious if there was anything that you would attribute to that.

<A - Carol B. Tomé>: I wouldn't read anything to shrink for the year. Shrink was up 1 basis point. This is just a y-over-y comparison.

<Q - Daniel Thomas Binder>: And then the last question, if I could. Given the strength in e-commerce, is there any implications on the profitability or profit headwind as the e-commerce business grows within the broader mix of the sales?

<A - Craig A. Menear>: Yeah, as we have shared in the past, we actually think about this as one business, that's the way the customer thinks about it. And so we handle this from a portfolio approach, and we look at a blended operation, because that's really where the customer is taking us with 45% of our orders being picked up in-store.

<Q - Dennis Patrick McGill>: Curious if you could elaborate a little bit on the Flooring category. It's been an area I think just in general in home improvement that hasn't been very robust even within your relative performance and to see that as a double-digit category, hoping you can maybe explain a little bit what was driving that.

<A - Edward P. Decker>: Sure. You've heard us talk over the last several quarters about our investments in hard surface materials. And those businesses continue to do very well with laminate very strong. We're getting great product innovation on vinyl flooring. So today's vinyl flooring is not the 1950s and 1960s kitchens laminate in – or vinyl, rather. And so you're starting to see what's called Luxury Vinyl Plank introduced into many use cases. Tile continues to perform very well. But the thing that is really working for us right now is the soft side. You haven't heard us talk about the soft side in some time; our hard set has been doing great for several quarters. And we're now seeing the soft side pick up very significantly. So we have both ends of that business working for us right now, which is what produced the double-digit comps.

<Q - Dennis Patrick McGill>: And that acceleration, Ted, from third quarter to fourth quarter was on the soft side, and was there any type of promotion or installed promotion-driven – driving that?

<A - Edward P. Decker>: No. No promotion at all.

<Q - Dennis Patrick McGill>: Okay. And then, Carol, on the capital spending plan of $2B, in the grand scheme of things, I guess it's not that much, but up from $1.6B in 2016. How much of that is definitely coming through vs. things that might be planned and could potentially be pushed out? And just wanted to make sure that's the right comparison, the $2.0B to the $1.6B.

<A - Carol B. Tomé>: The comparison is correct. We are planning to spend the capital that we are guiding to of $2B. It's about 2% of sales. And as you think about capital for our business going forward, if you want to model 2% of sales, I think that would be a good number to use. We're investing in the initiatives that we've shared with you, be it interconnected retail, supply chain; we are also investing into our stores.

As Craig pointed out, 45% of our online orders are picked up inside of our stores, that means we need to do some reconfiguration to hold those orders, and make sure the experience is right. We did a lot of work with our customers this summer and got some good feedback from our customers about things we could do differently in our stores. So 500 of our stores will be receiving what we call a new store environment, [indiscernible] (47:43) lighting, the floors are going to be polished up. The stores are relevant, we want to keep them that.

<Q - Dennis Patrick McGill>: Okay, that's helpful. And, Carol, you mentioned the breach cost I think in Q4, is that right? And so do you have a number?

<A - Carol B. Tomé>: It's $11mm in the quarter, $37mm for the year, $298mm life to date, and I think we're done. We're happy about that.

<Q - Matthew J. Fassler>: My first question relates to capital allocation. We obviously took note of both the dividend hike and the change in the payout ratio, as well as the new buyback authorization. Over the past couple of years, you've bought back more stock than you had initially guided to. Can you talk about whether the higher payout ratio would change your ability or your inclination to do so, I guess if the price was right, of course? And also just remind us of the leverage targets that you're thinking about.

<A - Craig A. Menear>: I think we've guided at the beginning of each year based on the cash flow projections that we have for the business. We still have a target of 2 times debt to EBITDAR ratio that is something that our board is comfortable with, so it's possible that we could expand.

<A - Carol B. Tomé>: Yeah, if you look at where the adjusted debt to EBITDAR ratio stands today, there's $2B of borrowing availability. It's not our intent to let that ratio decline, which it will if we don't lever back up. The interest rate environment is still very attractive. We're very pleased with how we've utilized debt financing to supplement our cash to buy back our share. So certainly not suggesting that anything is going to change off of our past practice.

<Q - Matthew J. Fassler>: And then – thank you for that. And then my second question, my second question – thank you for that. My second question relates to big ticket in Q4. So this was the third straight year that your big ticket comp was strongest in Q4, and obviously you've been putting up amazing multiyear comps in aggregate in Q4, but big ticket seems to be the biggest driver. If you would talk about either changes in your selling push or in buying patterns, is it better traction in Appliances? Is it the Pro push in Q4? Is it marketing across a broad array of seasons? What is it that is driving your transactions over $900 to such a great degree in Q4 more so than over the rest of the year?

<A - Edward P. Decker>: Sure, Matt. I'd say, first of all, that what we really like in the business is the balance. So, as Carol and Craig said, our comp in the U.S. stores was 6.3% in Q4; it was 6.2% for the year. We have an even balance of ticket and transactions. In Q4, it was roughly 3% for each of ticket and transaction. We're getting growth in our small ticket. We're getting the growth that you're asking about in big ticket, and we're also seeing an increase in items per basket. So just that breadth of performance across the store we like very much.

What's driving the outsize gains for another quarter in big ticket is really, you named them, so we continue to drive the Appliance business in Q4. Appliance has become a big selling period, but traditionally, the Black Friday period in retail. Our Flooring business that I talked about helped drive that ticket. And then the broad strength of the Pro across the entire store is the third large element driving that outsize comp in big ticket.

<Q - Seth M. Basham>: My question is around SG&A, specifically labor optimization. You mentioned this in the past as a potential initiative for 2017. If you can provide update on how you are thinking about it now that would be helpful.

<A - Craig A. Menear>: Yeah. And when it comes to optimizing, we're looking at that across multiple aspects of our business. We on occasion look at the structure within our business and we have organizational changes. This past year, for example, we brought together our online and marketing teams because that's really the direction of where the business is going. So we're continually looking at how do we optimize and drive productivity within our business around the SG&A.

<A - Carol B. Tomé>: And certainly, Craig, you commented on what we're doing with freight inside the store.

<A - Craig A. Menear>: Yes. And this is an area that in 2016 really is the first year that we've begun to focus on freight handling inside our stores. It's an area of opportunity for us as we continue to leverage the work that we've begun with supply chain Sync, but really optimize how we flow product inside the stores. I've talked about in the past that what we'll ultimately have to get to in our stores is handling product inside the buildings as efficiently as we do in our DCs.

<Q - Seth M. Basham>: Got it. So as you look at the forecast for SG&A growth in 2017, does it contemplate much in the way of labor productivity savings?

<A - Carol B. Tomé>: No material change to what you've seen in the past several years