Q2 2018 Earnings Call

Company Participants

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

Other Participants

- Beryl Bugatch, Analyst
- Brian Nagel, Analyst
- Christopher Horvers, Analyst
- Chuck Grom, Analyst
- Geoff R. Small, Analyst
- Jonathan Matuszewski, Analyst
- Matthew J. Fassler, Analyst
- Matthew McClintock, Analyst
- Michael Lasser, Analyst
- Seth I. Sigman, Analyst
- Simeon Ari Gutman, Analyst
- Steven Forbes, Analyst
- Zachary Fadem, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen. Thank you for standing by. Welcome to The Home Depot Second Quarter 2018 Earnings Call Conference Call. Today's call is being recorded.

At this time I'd like to turn the conference over to Isabel Janci. Please go ahead.

Isabel Janci {BIO 20990226 <GO>}

Thank you and good morning, everyone. Joining us on our call today are Craig Menear, Chairman, CEO, and President; Ted Decker, Executive Vice President of Merchandising; and Carol Tomé, Chief Financial Officer and Executive Vice President, Corporate Services. Following our prepared remarks, the call will be open for questions. Questions will be limited to analysts and investors, and as a reminder, we would appreciate it if participants would limit themselves to one question with one follow-up. If we are unable to get to your question during the call, please call our Investor Relations department at 770-384-2387.

Before I turn the call over to Craig, let me remind you that today's press release and the presentations made by our executives include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These statements are subject to risks and uncertainties that could cause actual results to differ materially from our expectations and projections. These risks and uncertainties include, but are not limited to, the factors identified in the release and in our filings with the Securities and Exchange Commission.

Today's presentations will also include certain non-GAAP measures. Reconciliation of these measures is provided on our website.

Now, let me turn the call over to Craig.

Craig A. Menear {BIO 15126612 <GO>}

Thank you, Isabel, and good morning, everyone. We're very pleased with our performance in the second quarter, achieving a milestone of the highest quarterly sales and net earnings results in our company history. Sales for the second quarter were up $30.5 billion, up 8.4% from last year. Comp sales were up 8% from last year, with U. S. comps of positive 8.1%. Diluted earnings per share were $3.05 in the second quarter.

Our results in the second quarter reflected what we call the bathtub effect. As expected, the majority of seasonal sales we missed in the first quarter were recovered in the second quarter. We also continue to see broad-based strength across the store in all geographies. In the U.S., all three of our divisions posted positive comps in the second quarter, as did our 19 regions and top 40 markets.

Internationally, Canada and Mexico posted mid-to-high single-digit positive comps in local currency during the quarter. Our solid performance was driven by the outstanding execution of our store associates, merchants, suppliers, and supply chain teams. Navigating a sudden spike in demand, like the one we witnessed in May, isn't easy. For example, in the Northern Division, the variability in sales over a two-week period of time was as high as 2,770 basis points, as the weather turned more favorable.

As Ted will detail, both ticket and transactions grew in the quarter. We saw a healthy balance of growth from both our pro and DIY categories, with pro sales once again outpacing DIY sales in the quarter. The alignment of our Interline and legacy outside sales forces around four targeted end markets continues to gain traction. These sales professionals are experts in their respective fields providing valuable insight and partnership to the pro customers that they serve. This in turn drives greater engagement and incremental spend.

Our digital business continued to be a source of growth. Online traffic growth was healthy and second quarter online sales grew approximately 26% from the second quarter of 2017. Customers continue to respond to ongoing investments and enhancements we are making in support of the customer experience.

Delivering a best-in-class interconnected shopping experience encompasses much more than our digital properties and physical store assets. Our supply chain and the investments that we are making to enhance the delivery and fulfillment options available for customers is also an important area of focus. We have continued to develop and roll out new delivery capabilities. We've now rolled out small parcel express delivery from store via car and van in nearly all our major markets in the U. S., with plans for further expansion.

Additionally, we told you that 2018 would be the year of the pilot as we test and learn with new fulfillment centers. I'm pleased to report that we are on track with our plan and opened our first MDO, or market delivery operation, during the quarter. In the second half of this year we plan to open additional facilities.

The opening of these facilities is a cross-functional endeavor. From our real estate team that locates the appropriate sites, to our IT teams that develop the proprietary software that runs them, and our supply chain team that owns execution throughout, the build-out of the One Home Depot Supply Chain is truly a collaborative team effort. I want to commend everyone for their work thus far in getting our five-year journey off to a strong start.

Let me touch briefly on the progress that we're making with some of our store investments. We've implemented our wayfinding sign and store refresh package in over 500 stores year-to-date, ahead of our initial plan. We also continue to make progress on the roll out of our redesigned frontend areas and BOPIS lockers, among other investments.

We're only seven months into a three-year investing journey. We remain energized and excited about the work and the opportunities ahead. We're focused on improving the customer experience by investing in our business and in our associates.

Turning to the macro environment, the U.S. economy and drivers for home improvement spending are strong. As Carol will detail, because of our outperformance in the first half versus our plan, we are increasing our sales and earnings per share guidance for the year. We now expect fiscal 2018 sales growth of approximately 7% and diluted earnings per share of $9.42.

I want to close by thanking our associates for their hard work and continued dedication to our customers, as they once again successfully navigated our busiest selling season.

Based on the first half results, 100% of our stores qualified for Success Sharing, our profit sharing program for our hourly associates. We are very proud of their efforts.

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

Edward P. Decker {BIO 16614891 <GO>}

Thank you, Craig, and good morning, everyone. We had a strong quarter with results that exceeded our expectations. The team did a great job of maintaining excellent service levels, while preserving high in-stocks over a period of elevated demand. Our core business continues to perform well and as expected, we saw record sales in our garden business, as spring broke across the country.

Looking at our departments; Lumber, Indoor Garden, Outdoor Garden, and Electrical had double-digit comps in the quarter. Tools and Appliances were above the company average. All of the departments, but Lighting, posted mid-to-high single-digit comps. Lighting had a low single-digit negative comp, driven primarily by LED price deflation.

In the second quarter, comp average ticket increased 4.9% and comp transactions increased 2.9%. Commodity price inflation in Lumber, Building Materials, and copper positively impacted average ticket growth by approximately 119 basis points. In addition to core commodity inflation, we are now experiencing inflation in other areas. These inflationary pressures come in many forms, including rising raw material costs and transportation costs, along with recently enacted tariffs. However, as the customers advocate for value, it is our job to work with our partners throughout the value chain to manage these pressures.

Turning to big ticket sales in the second quarter, we've previously defined big ticket sales as transactions over $900. Today, we are redefining big ticket sales as transactions over $1,000, as they now represent approximately 20% of U.S. sales. In the second quarter, transactions over $1,000 were up 10.6% compared to the second quarter of fiscal 2017. A few drivers behind the increase in big ticket purchases were vinyl plank flooring, appliances, and strength with our pro customers.

In the second quarter, sales to our pro customers grew double digits. Pro-heavy categories, like lumber, in-stock kitchens, power tools, windows, and concrete, all recorded double-digit comps. As you heard from Craig, our professional sales force is driving stronger relationships and a deeper level of engagement with our pro customers, which in turn lead to higher sales. This partnership is particularly important with our MRO customers, where we saw strong mid-single-digit growth in the quarter.

Sales to our DIY customers also showed solid results, as they completed a variety of spring projects. Categories like lawnmowers, watering, patio, ceiling fans, and interior and exterior paint, all had strong comps. In fact, our interior paint business had its best half performance in more than five years. And while the favorable weather drove outdoor project activity, we also saw good performance for maintenance and repair categories during the quarter, with great results in water heaters, HVAC, safety and security, and air circulation.

During the quarter, we held our annual Memorial Day, Father's Day, and Red, White and Blue events. Our merchants, merchandising execution team, and stores did a fantastic job bringing great value to our customers, which helped drive transactions both in-store and online.

As part of our focus on balancing the art and science of retail, we have created approximately 50 cross-functional squads focused on agile development to improve the flexibility and ease of our online customer experience. As Craig called out, we saw strong growth in our online business, driven in part by an increase in our conversion rates. And our interconnected retail offering is resonating with our customers, as 47% of all of our online orders are picked up in the store.

Now let's turn our attention to the third quarter. We are thrilled to announce our new appliance partnership with Bosch. Bosch is one of the largest home appliance manufacturers in the world and brings over a century of product innovation and engineering to The Home Depot. We are excited to offer broad selection of their appliances both in-store and online. Most notably, Bosch is recognized as having the quietest and most reliable dishwasher on the market today and they own the number one brand position in the category.

Building on the success and momentum of our LifeProof carpet and vinyl plank, we are excited to introduce LifeProof slip resistant tile. LifeProof tile is 50% more slip resistant than ordinary tiles and is particularly good for wet areas, like bathrooms, kitchens, and even outdoor patios. The innovative coating eliminates the need for a gritty texture and does not freeze, fade, or crack. It is low maintenance and easy to clean. LifeProof tile is exclusive to The Home Depot.

We're also excited to be introducing some great new innovation across our Husky tool portfolio. The growing Husky brand is owned and backed by The Home Depot, and offers incredible value to our customers who need tough quality tools and storage at affordable prices. In mechanics tools, we're introducing new impact sockets that offer easier access in tight spaces. And in plumbing tools, we're introducing a ratcheting PVC pipe cutter that requires less force to cut and allows for easy single hand operation. All of our Husky hand tools are backed by a lifetime warranty and can be replaced at any of our stores.

In addition to great new products, we're excited about our upcoming events. As summer winds down and cooler temperatures arrive, we will have an incredible lineup of great values and special buys for our customers during our Labor Day and Halloween and harvest events.

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

Carol B. Tomé

Thank you, Ted, and good morning, everyone. In the second quarter, total sales were $30.5 billion, an increase of 8.4% from last year. Recall that at the beginning of fiscal 2018, 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 profit. In the second quarter, the change in accounting positively impacted sales growth by $33 million.

Our total company comps were positive 8% for the quarter, with positive comps of 11% in May, 7.5% in June, and 5.7% in July. Comps in the U.S. were positive 8.1% for the quarter, with positive comps of 10.6% in May, 7.6% in June, and 6.3% in July.

As you heard from Craig, our second quarter performance exemplified what we call the bathtub effect of a seasonal business. In other words, the majority of the seasonal sales missed in the first quarter due to inclement weather were recovered in the second quarter. And as you've heard, we didn't just recover seasonal sales. Our total sales growth exceeded our expectations.

One last comment on sales for the quarter. Foreign currency exchange rates had a negligible impact on sales growth.

In the second quarter, our gross margin was 34%, an increase of 36 basis points from last year. There were a number of factors that impacted our gross margin performance year-over-year, two of which can be isolated and the third is just the net result of a number of factors. Specifically, we had $152 million of gross profit, or 46 basis points of gross margin expansion, due to the new accounting standard.

We reported 16 basis points of gross margin contraction due to higher transportation and fuel costs in our supply chain. And finally, we had 6 basis points of gross margin expansion due to the net result of a number of factors, including sales mix and the impact of recently acquired companies.

For the year, we expect our gross margin rate to expand by approximately 41 basis points. This expansion is down slightly from our previous guidance due to higher than anticipated transportation costs in our supply chain. In the second quarter, operating expense as a percent of sales increased by 16 basis points to 17.9%, reflecting 90 basis points of expense leverage in BAU, or business as usual, offset by the impact of the new accounting standard and expenses associated with the strategic investment plan we laid out at our December investor conference.

Expanding on this, the new accounting standard resulted in a $152 million increase in our operating expenses and caused 48 basis points of operating expense deleverage. And expenses related to our strategic investment plan of roughly $174 million resulted in approximately 58 basis points of operating expense deleverage.

Given our strong first half performance, we now expect our fiscal 2018 operating expenses to grow at approximately 137% of our sales growth rate. Our operating margin for the second quarter was 16.1%, an increase of 21 basis points from last year. For the quarter, interest and other expense decreased by $3 million to $246 million, and our effective tax rate was 24.7% compared to 36.6% in the second quarter of fiscal 2017. The decrease in our effective tax rate reflects, for the most part, the benefit of tax reform. For the year, we continue to believe our effective tax rate will be approximately 26%. Our diluted earnings per share for the second quarter were $3.05, an increase of 35.6% from last year.

Moving on to some additional highlights. During the quarter, we opened one new store in Mexico for an ending store count of 2,286. Selling square footage at the end of the quarter was 238 million square feet. Total sales per square foot for the second quarter were $504, up 8.6% from last year. At the end of the quarter, merchandise inventories were $14 billion, up 9.1% from last year. Inventory turns were 5.4 times, up one-tenth from last year.

In the second quarter, we repurchased $2 billion, or approximately 9.3 million shares, of outstanding stock. This included approximately 2.1 million shares on the open market and approximately 7.1 million shares repurchased through an accelerated share repurchase, or ASR, program. We also received approximately 874,000 shares related to an ASR program we initiated in the first quarter.

Note that for the shares repurchased under the second quarter ASR, it is an initial calculation. The final number of shares repurchased in the second quarter will be determined in the third quarter, when the second quarter ASR terminates. Year-to-date, we have repurchased approximately $3 billion of our outstanding shares and now we expect to repurchase approximately $6 billion of our outstanding shares for the year.

Computed on the average of beginning and ending long-term debt and equity for the trailing 12-month, return on invested capital was approximately 37.9%, 590 basis points higher than the second quarter of fiscal 2017. As we look to the back half of the year, we continue to expect strong economic growth, with the backdrop of a healthy home improvement environment. Homeowners continue to enjoy home price appreciation, and rising wages and low unemployment have driven consumer confidence to record high levels.

These trends are all supportive of our business, but we also know that in the second half of fiscal 2017 we experienced over $600 million of hurricane-related sales that we must comp. So today we are lifting our fiscal 2018 guidance primarily for our first half outperformance. Now, if there's a bias in our forecast, based on the economic environment and our August performance to-date, the bias is to be up.

Now, remember that we guide off GAAP. Recall that fiscal 2018 will include a 53rd week, so the fourth quarter of fiscal 2018 will consist of 14 weeks. For fiscal 2018, we now expect sales to increase by approximately 7%, with positive comps, as calculated on a 52-week basis, of approximately 5.3%. For earnings per share, we expect fiscal 2018 diluted earnings per share to grow approximately 29.2% to $9.42. Our earnings per share guidance includes our intent to repurchase approximately $3 billion of outstanding shares in the back half of fiscal 2018.

So with that, I would like to thank you for your participation in today's call. And, Kath, we are now ready for questions.

Q&A

Operator

Thank you. Our first question will come from Simeon Gutman with Morgan Stanley.

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

Thanks. Good morning, everyone. Nice quarter. I wanted to first ask about the macro, probably will be a busy topic on it this morning. Look, there's a lot of noise out there, there's a lot of healthy metrics, but there's also some cautionary ones. So curious, I guess, the big one is home improvement demand and how it sort of disaggregates from declining existing home sales. Your guidance clearly doesn't imply that there's any reason to be worried, but curious how you look at the world now.

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

Simeon, we feel very positive about the strength of the home improvement sector and the customers' willingness to spend. And I'll let Carol walk you through some of the details of how we actually think about it.

A - Carol B. Tomé

Yeah. We've expanded our thinking in this regard. We look at all housing metrics, housing turnover, home price appreciation, new household formation, the age of the housing stock, and of course, housing starts, although that isn't as directly impacted to our business as the others. And what we've learned is that you can't to look at any housing or home improvement driver in isolation, because they all play off each other.

Let's take housing turnover as an example. Housing turnover now stands at about 4% of units, and that is in part because we have a housing shortage in our country. We only have 4.1 months of supply against a normal month of supply, more like six months of supply. And with the housing shortage, home prices have appreciated. With home price appreciation, homeowners have more equity in their homes. In fact, home equity values have increased over 120% since 2011, about $73,000 per homeowner, in terms of equity. So as homeowners view their home as an investment and not an expense, they spend more.

If we look at correlating our comp sales against housing turnover going back to that number, to your point, we're disconnected. And we think that really has to do with this housing shortage. In a normal housing environment where there's adequate supply, you see a pretty tight correlation between our comp sales and housing turnover. But now because we've got this housing shortage, it's disconnected. And I could go on and on about the macro, because I know there are number of other things we could talk about. Craig, I don't know if you want me to continue on or pause.

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

And, I think, probably the biggest question that we get is around affordability as it relates to the housing environment. And with the increase in interest rates – when do we get worried about affordability? And again, Carol can walk through how we think about affordability, but affordability factor with interest rates doesn't impact the majority of folks.

A - Carol B. Tomé

Yeah. I think it's still very important – when you think about the Affordability Index and we've talked to you about this in the past, right now the Affordability Index for the country is 144, and if you look at the historical average it's 127. So in the past we said, well, if it gets to 127, that could be a watch out for us. But as we thought about it, we thought really you need to think about it on the margin, because the only 4% of housing units are turning in a year, that means 96% of homeowners are staying in their home.

And they don't care about rising interest rates. And, in fact, they love rising home prices, because their equity is worth more. So really when you think about affordability, it's the 96% of the housing units that are in place that are driving the home spend (00:25:50), and not so much the marginal turnover that the media tends to pay attention to.

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

So thanks for all that. And, I guess, just following up on affordability, you have this visibility, we don't, right? There are some markets in which the Affordability Index has dropped a little more severe than the average. I know this quarter was really about seasonal and bathtub effect. But can you disaggregate those markets in which the affordability has deteriorated the most, and then what the top line trend, anything, in those markets of note?

A - Carol B. Tomé

Yeah. So let's just take Seattle. Seattle, the home prices have been on fire and on fire for a while. Our comp in the Seattle market in the second quarter was 7.7%.

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

Right, got it. Okay. Well, thank you.

A - Carol B. Tomé

Thank you.

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

Thanks.

Operator

Our next question comes from Chuck Grom with Gordon Haskett.

Q - Chuck Grom {BIO 3937478 <GO>}

Hi. Thanks. Just on the expense front, Carol, your growth factor saw a little bit of a step down here versus the pace in the first quarter despite the better comp. Just wondering if you could frame out some of the components for us, the BAU, and then also looking ahead into the third and fourth quarter how you see it framing up.

A - Carol B. Tomé

Sure. So in the second quarter, as we talked about on our prepared remarks, we had 90 basis points of expense leverage in BAU. And if you look at the drivers of those 90 basis points, roughly 50 of the basis points came from payroll and payroll-related items. You've heard Ann-Marie Campbell talk about a new labor model that she's introduced into the stores. We're driving productivity in our stores, while at the same time increasing our customer reports. Our customers are very happy with the service that they're getting in our stores. The rest of the leverage came from leveraging fixed costs as well as everything else. I mean, productivity is a virtuous cycle here at The Home Depot. When you put up a comp of 8%, you expect to get pretty good expense leverage and indeed, we did.

As we think about the balance of the year, our expense growth factor for the first half of the year was 139%. We would expect it to be around 135% for the back half of the year, giving us the guidance that we gave you of 137%. And just a comment on the quarters, we would think the expense growth factor would be slightly higher in the third quarter than the fourth quarter, because remember, the fourth quarter has that extra week.

Q - Chuck Grom {BIO 3937478 <GO>}

Okay, great. That's very helpful. And then just, Craig, on the MDOs, you said you opened up one so far. Just any early learnings so far? Can you quantify how many you think you're going to do in the back half of the year? And bigger picture, how do you frame out the opportunity across the board?

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

First of all, it's very, very early to gather any learnings. We just got the facility opened, but we're up and running and, obviously, learning as we go. We actually won't disclose how many we open in the back half. But if you think about the approach to this, and I'll let Mark jump in here, it is using the advantage that we built in our upstream network to actually feed the downstream opportunity that we have to continue to drive the way the customer wants to engage with us. And, Mark, I don't know if you have any additional comments.

A - Mark Holifield {BIO 5952851 <GO>}

Right. The market delivery operation that we've opened is just part of our overall plan to drive the fastest, most efficient delivery in home improvement. Just getting started there, so it's very early days in terms of that, but this is one of those stockless locations, that's a delivery hub in a local area, and we deliver primarily appliances out of there at this point, but we'll be adding more products to that as we go. Expect more and we'll keep you posted as we go in the second half and beyond.

Operator

Thank you. We'll continue on to Michael Lasser with UBS.

Q - Michael Lasser {BIO 7266130 <GO>}

Good morning. Thanks a lot for taking my question.

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

Good morning.

Q - Michael Lasser {BIO 7266130 <GO>}

If we average out your comp transactions between the first and the second quarter to account for the seasonality and the seasonal shift between those two periods, it looks like it was up around 0.7%. That represents the slowest traffic growth in the last few years. Do you think that's a sign that maybe the cycle is entering the later stages, and what would cause that to reaccelerate from here?

A - Carol B. Tomé

So we probably need to look at your math. But when we look at our transactions for the second quarter and back out garden, our seasonal business, our comp transaction was up 1.6%.

Q - Michael Lasser {BIO 7266130 <GO>}

Okay. That's helpful. And given all the discussion about tariffs and inflation, maybe you can tell us about your performance in the appliance category, particularly washing machine, because that has been an area where there has been significant pricing pass-through. And based on that experience, how do you see the next few quarters unfolding in terms of the elasticity of demand as you try and navigate through what's probably going to be a hotter inflationary environment?

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

Michael, I would say at this point that the tariff environment is manageable. And given our sales and our size and scale, it's even that much more manageable. Overall, on the lumber tariffs with Canada and the laundry tariffs on washing machines, as you mentioned, in the Section 301s that have come through, this is all low single-digit percent of our COGS and just 25-odd basis points of cost pressure. I mean, we are seeing increased cost requests from suppliers, particularly the ones that have been impacted by the tariffs. But, as you can see, the overall size is very manageable at this point.

Now, there are some categories, and laundry being the most specific, where you had up to 25% and 50% tariff if you get over certain volumes of imports. For sure, that elasticity showed up. You had mid-teen increase in the industry with laundry prices and you did see some unit fall-off there. But as the Korean manufacturers get their facilities up and running in Tennessee and South Carolina, respectively, that tariff pressure will mitigate, because they'll be producing all their machines here domestically.

Q - Michael Lasser {BIO 7266130 <GO>}

And just a follow-up on that. Is there anything that you can learn from the experience with washing machines that you might be able to apply to other categories, especially those ones that will be affected by the next round of tariffs?

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

Sure. I think we take a portfolio approach to this and we do not – these tariffs are very specific. I mean, they're calling out products with specific dimensions. So it's not always even a category of goods. It's a specific unit or number of units within a category of goods. So, yes, we apply learnings on elasticity and we're not necessarily taking a one-for-one retail with the cost increase. We manage it at the portfolio level. And as I said, with this gross less than low single-digit percent of COGS, well within our scope to manage this at the portfolio level.

Q - Michael Lasser {BIO 7266130 <GO>}

Thank you so much and good luck.

Operator

Our next question comes from Kate McShane with Citi.

Q - Geoff R. Small {BIO 16983001 <GO>}

Hello. This is Geoff Small on for Kate McShane. Thank you for taking our questions. We want to first dig into the second quarter sales result. You mentioned that the majority of lost sales from the first quarter were recovered in the second quarter. We're just wondering if you could quantify that amount and provide color if there'll be any ongoing benefit in third quarter. And just curious if you saw any ongoing benefit from the hurricane recovery in your second quarter results as well.

A - Carol B. Tomé

Yeah. We can unpack that 8% comp for you this way and I'm going to round to make it easy. About 2 points of growth came from our seasonal business. About 1 point of growth came from the index-based commodity categories that Ted called out on his call. Another 1% (sic) [1 point] came from hurricane-related sales, and then the remaining 4 points came from everything else.

Q - Geoff R. Small {BIO 16983001 <GO>}

Understood. That's helpful. And just also wanted to dig into the comp performance of your newly remodeled and refreshed stores. I think 250 were completed in the first quarter, and you're now through 500 of those stores. Can you provide any detail on the comp performance of those refreshed stores? And we're just also curious how many refreshes or remodels you expect to complete over the course of this year.

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

Geoff, obviously, for competitive reasons, we're not going to call out performance of those stores, but we're continuing to roll that through the back half of the year.

A - Carol B. Tomé

Yeah, we're really excited about the execution of this initiative. In fact, if you look at the capital that we spent for the first six months of the year, 50% of that went into the stores. Our team's just doing a great job of putting in everything we said we were going to do.

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

Yeah, we're super excited. So, the greatest penetration of stores look at our (00:35:56) new wayfinding and sign package, which really brightens up the store and makes navigation of the store much easier. We also do, call it, a general environmental cleanup of the stores (00:36:09) the floors, add lighting, paint, remodel restrooms/break rooms for the associates, et cetera. So, very pleased with the look and feel. And our customer sat scores are trending up as we roll that out.

As Craig mentioned, we're doing lockers. We're rolling lockers out, revamping some frontends at the store, putting buy online, pick-up in store storage lockers into the stores, and also very excited to be rolling out electronic shelf labels. We've not done this in the past. We're starting with our appliance department and we'll do over half the stores this year with, sort of, iPad-sized electronic price signs and information on the appliance in our appliance departments.

A - Carol B. Tomé

So this is not for the faint of heart, right? There's a lot going on inside the stores. But we piloted this for over a year before we even started to roll, and perhaps that's one reason why we're rolling faster than we thought we might.

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

Right.

Q - Geoff R. Small {BIO 16983001 <GO>}

That's very helpful. Thank you very much and best of luck in the third quarter.

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

Thank you.

A - Carol B. Tomé

Thank you.

Operator

We'll now hear from Steve Forbes with Guggenheim Securities.

Q - Steven Forbes {BIO 20413212 <GO>}

Good morning.

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

Good morning.

Q - Steven Forbes {BIO 20413212 <GO>}

Regarding gross margin, so were there any surprises this quarter? You called out transportation headwinds 16 basis points, which I think is up about 8 basis points sequentially, but shrink wasn't called out. So is shrink improving? And how do you expect that transportation headwind to trend as we move into the back half of the year?

A - Carol B. Tomé

So we, like the rest of the nation, are facing higher transportation and fuel costs, and we reflected that in the guidance that we gave for our gross margin for the year now we expect an expansion of 41 basis points for the year. Last quarter we expected 44 basis points. So we have factored that – we're doing our best to manage through it, but there's a real issue in the transportation markets in our country.

On the shrink side, shrink was one of those other factors. I called out the drivers of gross margin performance, the change in accounting, transportation, and then all other, shrink was in that all other bucket of 6 basis points of expansion. It was actually a hurt in the quarter, but we were able to offset with actually the benefits coming off of the newly acquired companies. We've got a cross-functional team that's working on shrink. And just yesterday we had a really great report out and have hired a new Loss Prevention Officer into our company, and we're excited about that.

Q - Steven Forbes {BIO 20413212 <GO>}

And then just a quick follow-up, Craig, because you called out that 100% of the stores qualified for profit sharing this quarter. How does that compare to last year as we conceptualize the year-over-year impact from the stronger performance of the business broadly, and how do we think about that impact for the full year?

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

So as for the first half – and if I recall correctly, I think for the first half last year we were 100% for our stores as well, I believe.

A - Carol B. Tomé

Yeah. We might have (39:23)

Q - Steven Forbes {BIO 20413212 <GO>}

(39:24) Yeah, might have been two stores that missed last year.

A - Carol B. Tomé

Yeah.

Q - Steven Forbes {BIO 20413212 <GO>}

Thank you.

A - Carol B. Tomé

Yes, you bet.

Operator

Our next question comes from Seth Sigman with Credit Suisse.

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

Thanks for taking the question. Nice quarter, guys. A couple of follow-up questions here. First, just in terms of the inflation impact on comps that you talked about, just to clarify, it sounds like the bulk of the impact is really just on commodity items at this point. I wasn't sure. Are you expecting to see more increases in some of the non-commodity items as you move through the year? And then I'm also just wondering, from a competitive perspective, are you seeing any of your competitors handle the inflation differently, meaning maybe not pass as much through, get more aggressive, et cetera? Thanks.

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

So yes, at this point by far the largest impact is the 119 basis points that we called out from core commodities. And there are puts and takes in that, but for the most part, Seth, lumber, for example, is priced weakly. And you might have some differential on a SKU or market here or there. But those tend to be priced competitively by everyone across the marketplace.

We don't see large impacts in the second half from the non-commodity. And, in fact, commodity has come down meaningfully. Lumber and copper each, which are behind the 119 basis points, have moved down over the last eight weeks. So if you look at lumber prices, we are now on framing only 4% ahead of last year and the peak there was about 40%. So we're not going to see the same lumber inflation in the back half.

Panel prices again were 35% or 40% above LY, and that's now at about 1% over last year. The good news is we spoke about elasticity earlier. I mean, at 40% increase, and we saw such a sharp and quick run-up in lumber prices, we were starting to see an impact in units. But over the last six, seven, eight weeks, these prices have come down. Units have responded nicely. So we'll take the volume any day over price in commodities.

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

Okay. Thanks for that color. And then my follow-up is on the digital business, up 26%, a nice acceleration. I think it contributed 170 basis points to the comps, which is really one of the strongest we've seen. So my question is, is this driven by the seasonal shift? Was there a benefit from that or something else that may be you can point to that you think is driving that strength? And I think a lot of it is still coming from the store or picked up in the store. I'm just curious what you're seeing that's helping drive that acceleration. Thanks.

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

Yeah, I'll make a comment and I'll turn it over to Kevin. Overall strength in our online business, but certainly supported as well with the seasonal categories. So it's interesting that seasonal businesses pick up in the online space just like they do in the physical space.

A - Kevin Hofmann {BIO 19136140 <GO>}

Yeah. And certainly we saw balanced growth with both traffic and conversion. As we continue to just manage the shift to mobile as well, we had really solid progress with our mobile properties. And while we have strength across the store, as Craig mentioned, real strength in the seasonal business has really helped.

A - Carol B. Tomé

And 47% of our online orders are picked up inside of the store, so that we're really driving this interconnected experience.

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

Great. Thank you.

Operator

Thank you. Our next question comes from Matt McClintock with Barclays.

Q - Matthew McClintock {BIO 16452505 <GO>}

Yes, good morning, everyone. Just, Craig, you talked about rolling out small parcel across all major markets now. I was just wondering if you could maybe talk a little bit about the experience of what you're seeing in the business in those markets when that capability is rolled out. Thanks.

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

Sure. I'll make a comment and I'll turn it over to Mark. We're actually very pleased with what we're seeing here, and it gives us the capability to offer different value propositions to our customers. So, customer needs a smaller delivery. We can do that much more effectively and much faster for them. And then it's providing leverage into our overall delivery capability. Right, Mark?

A - Mark Holifield {BIO 5952851 <GO>}

That's right. I mean, again, on the theme of the fastest, most efficient delivery in home improvement certainly we're fast when we have car and van same-day delivery available from our stores in all of our major markets. We're almost there with all of our major markets. What we'd say about that is it's great, because that's incredibly fast, but it also has great coverage. We've matched our coverage of same-day delivery up against anyone in the marketplace. And we would say that our home improvement capability is unmatched in the marketplace. So, Kevin mentioned the drivers of digital growth. One of those is increased conversion due to faster delivery.

Q - Matthew McClintock {BIO 16452505 <GO>}

Thanks for that. And then, Carol, if I could ask a follow-up. Just on the macro, I understand you have to look at everything holistically. But is there any independent impact on certain product categories, with housing turnover being as low as it is? I'm just trying to parse through with the 96% of the people that are staying in their house, 4% that are moving, does that actually have an outsized impact on specific product categories or not? Thanks.

A - Carol B. Tomé

Let's just look at the math of housing turnover. With 4% of units turning, that's about 5 million households turning, and I'm looking at occupied households today. That's 5 million units turning. The average spend is $3,500 a unit. So that means the market opportunity for housing turnover is $17.5 billion. If you use our NAICS market share of 28%, that gets you $5 billion-ish of sales. So $5 billion-ish of sales on our base of $100 billion suggests that turnover just isn't that important.

And just for thought, I modeled what could happen using that simple math if turnover were to decline 15%. No one's projecting that, but model it just for fun. And the impact on comps, because again it's not very big, was less than 1%. So to your specific question about category specific, we have no insight there. But I bring it up to the 40,000 feet and say is this not that important.

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

I guess, the only comment I'll make on categories, if you think about the number one project would be painting, and you would think that if there was going to be an impact, it would be there. We just had our best paint quarter in five years.

A - Carol B. Tomé

Right, exactly, right.

Q - Matthew McClintock {BIO 16452505 <GO>}

Fair enough. Thanks for the color.

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

Yeah.

A - Carol B. Tomé

Yeah.

Operator

Our next question comes from Jonathan Matuszewski with Jefferies.

Q - Jonathan Matuszewski {BIO 20342817 <GO>}

Hey, guys. Thanks for taking my question. Could you talk a little bit to the traction you're having in home furnishings? It's a category, I believe, you're leaning into more with SKU count addition, so any color there would be helpful.

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

Sure, very early days, as you say. We're adding a number of SKUs in things like tabletop, in décor, in rugs, et cetera. Very early days but pleased with our traction, significant growth but on a low base. We've completed the integration of the company's store and one of our first integration moves was to list a lot of their better sellers on The Home Depot website. So that just went live some weeks ago and starting to see an uptick there. This is all a journey for our customers to find this product on our website and engage with The Home Depot in these adjacent, but we think very relevant, categories.

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

Yeah. If you think about the data that shows that average number of retailers the customers shopped in roughly the last four years has declined from 13 to 9. And our consumer research said that the customer trusts us to bring value and questions why we don't help them fulfill the balance of their needs in their home. This is an opportunity for us as we go forward, largely as this business continues to shift to the digital world. So you should think about this as a digital strategy.

Q - Jonathan Matuszewski {BIO 20342817 <GO>}

Great. Thanks so much. And then just a quick follow-up. Any updates on the B2B site that you're developing for the pros? Is that currently being piloted in select markets? Or any update there would be great. Thanks.

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

Sure. I'll let Bill address that.

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

Well, so when we talked about this last December, we said this was a two-to three-year journey. And it will be to build out all the tools and applications that our professional business customers need. And we're still in the customer intercept interview phase and we're in testing mode. So we'll probably get a couple of customers over on kind of a small test as we go through Q3, but we'll see more activity around this space in Q4.

A - Carol B. Tomé

We saw a demo of it yesterday, though, and the demo looked good. We got to get it now out of beta into (29:37) customer hands, but it looked pretty good.

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

Good progress as we lean into those – the initiative.

Q - Jonathan Matuszewski {BIO 20342817 <GO>}

Great. Thank you, guys.

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

Sure.

Operator

We'll now go to Matt Fassler with Goldman Sachs.

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

Thanks so much and good morning, everyone.

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

Good morning.

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

My first question relates to inventory. Obviously, you had a very healthy quarter and inventory was up around the pace of sales, but a bit more so than in Q1 and a bit above the rate of sales growth that you seem to anticipate for the second half of the year. So, any color on what drove the increase would be terrific.

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

So, Matt, the main thing there is, we're investing at accelerated (50:20) merchandising resets. The inventory, from a seasonal perspective, is in great shape. We're at record high levels of in-stock, which we thought was critically important to be able to capture the sales that we did in the second quarter. But the main reason for the increase is the add-on of new businesses and the investment in accelerated merchandising resets.

A - Carol B. Tomé

Right. And just the capital associated with our merchandising resets alone this year is $275 million, so we're investing into this for the long-term customer experience.

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

Got you. And then a second question just on the sales for the second half, you don't typically guide precisely to the quarter. So can you give us a sense of whether the second half sales guidance is – as you presented it today, what was implied in the business plan at the end of Q1? And then also any comments, just given the storm impact on Q3 versus Q4 and the anticipated pace of business.

A - Carol B. Tomé

Right. So based on the guidance that we gave today, the comp in the second half of the year would be lower than the first half of the year. But, Matt, the two-year stacks will be identical. So our two-year stack in the first half is over 12%, so that gives you a sense. There's no deceleration happening in the business.

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

Of course.

A - Carol B. Tomé

On the storm side, I called out about 1 point of growth from hurricane-related sales in the second quarter. We recovered $500 million of the $600 million we had last year. So we think we'll get another $100 million in Q3, Q4-ish, but remember, then we have to comp all the stuff. So this is a relative comparison. Does that make sense?

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

Got you. It does. And then finally, you spoke about inflation earlier in the call. You started to see inflation last year, which has been quite persistent. So any sense for the inflation backdrop embedded in that second half guide?

A - Carol B. Tomé

There isn't any.

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

We really didn't...

A - Carol B. Tomé

There isn't any.

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

We don't (00:52:16)...

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

Got you.

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

Matt, we're seeing the commodity side of the inflation mitigate. It's really going away, so...

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

Okay. Thank you so much, guys.

Operator

We'll now go to Budd Bugatch with Raymond James.

Q - Beryl Bugatch {BIO 1504748 <GO>}

Thank you very much for taking my question and congratulations on the quarter. Most of my questions have been asked, so I'm just going to go with one small question and talk about pro penetration. You've had some really great growth in pro. I think penetration last we knew was like 40% of sales. Has that moved off at all with continuing outpacing of pro?

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

Yeah, actually, we are seeing movement on that, as we've consistently had our pro business growth accelerate against our growth in DIY. So we are seeing that.

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

Yeah, Matt, this is Bill Lennie. We would take that pro penetration closer to 45% today, just we've seen several years of growth where pro's outpaced consumer. Consumer strength has been there, but with the activity in the home investment that Carol spoke to, the pro growth has exceeded that and we peg it at about 45%.

Q - Beryl Bugatch {BIO 1504748 <GO>}

And, Bill, to your particular area, the integration of the outside sales force and the inside sales force, can you give us a little bit of flavor of where that is in the Interline integration today? And you've made a lot of progress I know, but where is that and what have you been pleased by?

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

Yeah, Craig, in his opening comments, spoke about integrating our outside sales forces. That's been completed. We're seeing great collaboration across the organizations, which is allowing us to cross-sell between Interline's inventories and Home Depot's inventories. And then our sales professionals really provide a service beyond just product for our customers. They are experts in their field and with that, it does drive engagement. So we've seen great strength, both in store and outside of the store, and particularly with our MRO accounts. So that integration continues to progress nicely.

Q - Beryl Bugatch {BIO 1504748 <GO>}

Thank you very much. Good luck on the second half.

A - Carol B. Tomé

Thank you.

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

Thanks, Budd.

Operator

Thank you. Our next question comes from Zach Fadem with Wells Fargo.

Q - Zachary Fadem {BIO 18911015 <GO>}

Hey. Good morning. With respect to your online business, would you say there are any particular categories where you tend to over-index relative to your overall mix? And conversely, what are the categories that maybe haven't resonated with the consumers, haven't seen that response yet? Curious if you could talk about the dynamics there.

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

I actually think what I'd say is we're seeing kind of the opposite effect. I think there were categories that we anticipated the customer may not engage in the digital world, but that shopping experience actually starts in the digital world even if it finishes in the physical world. So if you think about things like flooring or doors, which you would traditionally think of as a category that will be purchased in store, in most cases the shopping experience actually starts in the digital world. So we've seen really nice engagement with across the customer really across categories.

Q - Zachary Fadem {BIO 18911015 <GO>}

All right. That's interesting. And to follow-up on the pro, could you talk about any impact you're seeing from your data initiatives and any evidence today that you're gaining share of the pro wallet? And then just with respect to the categories, where do you see the biggest opportunities to gain pro share? Thanks.

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

Just a quick comment on the pro data. We've, through my view and our tools, that's pro desk, have been able to provide better insights for our in-store pro sales associates. And we've seen growth across all of our managed accounts in our portfolios. But the fastest growing segment of our pro business is the pros that are in our stores and covered by our posses. So it just shows as we provide insights, we can give them some guided selling tools. They engage more with the customers can provide better insights for us what services and what products we can provide. That just leads to engagement and pro growth. So strength is really then outpaced in store versus our outside sales, which is all about execution in in-stocks and great relationships.

Q - Zachary Fadem {BIO 18911015 <GO>}

Got it. Thanks for the color. I appreciate the time.

Operator

Thank you. Our next question comes from Chris Horvers with JPMorgan.

Q - Christopher Horvers {BIO 7499419 <GO>}

Thanks. Good morning. A couple follow-up questions. Just the first question is there has been a lot of management changes at your largest competitor and I know it's early. But are you seeing any difference in terms of how they approach to market, whether from a customer service perspective yet or from a promotional perspective or any other changes?

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

Chris, our job is to focus on our customers. That's really what we're focused on doing.

Q - Christopher Horvers {BIO 7499419 <GO>}

Understood. And then besides appliances, you don't bake market share gains into your guide. Can you talk about how you assess your performance relative to the market, in 2Q overall did you gain share? And any sense on the breakdown in share between share capture and DIY versus pro?

A - Carol B. Tomé

Well, if only we had that insight into share capture DIY versus pro. As you know, market share is a bit elusive for us. The best we can do is look at the NAICS 4441. And if we look at the NAICS 4441, it would suggest that we gained share in the second quarter.

Q - Christopher Horvers {BIO 7499419 <GO>}

And then the last question, as you think about your outlook for market growth in the back half of the year, has there been any changes since you put out the initial guidance in 4Q or since the 1Q update?

A - Carol B. Tomé

No, home price appreciation is doing exactly what we thought it would do. Household formation is trending the way that we thought it would. The age of the houses, well, they're getting older. Housing turnover is the only one that's slowed down a little bit. But again it's not that important since it's a driver of spend, not a driver of growth.

Q - Christopher Horvers {BIO 7499419 <GO>}

Thanks very much, best of luck.

A - Carol B. Tomé

Yeah.

A - Isabel Janci {BIO 20990226 <GO>}

Kath, we have time for one more question.

Operator

Thank you. And our final question comes from Brian Nagel with Oppenheimer.

Q - Brian Nagel {BIO 6638066 <GO>}

Hi. Good morning. Congrats on a very nice quarter.

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

Good morning. Thank you.

Q - Brian Nagel {BIO 6638066 <GO>}

So most of my questions have been asked and answered. I just got really one quick one here. There's been a lot of discussion about lapping the hurricanes in the second half of this year. As we look what's happening now in the West Coast United States with fires out there, how does Home Depot typically react with that? Is there an initial wave of demand that comes? Is there a long-term demand that comes as a result of that activity? Thanks.

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

I mean, the first thing I'd say is, boy, our thoughts and prayers go to all the folks that are being impacted here. It's a horrible situation, for sure. And for us, the good news is that we don't have any structures that have been impacted, but we certainly have associates and customers who have been impacted. And just it's a tough situation, for sure.

Fires are a tough thing, because basically fires destroy everything and essentially you're in a new rebuild from that point forward. That's, obviously, not the focus of our business. It's not where our strength or focus is. So, no, it's a tough deal for those affected. And we feel for everybody that's going through this and certainly hope for the safety of all the folks battling the blazers or the first responders.

Q - Brian Nagel {BIO 6638066 <GO>}

Got it. Congrats again on the quarter. Thanks.

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

Thank you.

A - Isabel Janci {BIO 20990226 <GO>}

Thank you for joining us today. We look forward to speaking with you on our third quarter earnings call in November.

Operator

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