HD – Q1'23 Home Depot Earnings Call
EVENT DATE/TIME: May 16, 2023 / 09:00AM ET

PRESENTATION

Operator

Greetings, and welcome to The Home Depot First Quarter 2023 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Isabel Janci. Please go ahead.

Isabel Janci - *The Home Depot, Inc. - VP, IR & Treasurer*

Thank you, Christine, and good morning, everyone. Welcome to Home Depot's First Quarter 2023 Earnings Call. Joining us on our call today are Ted Decker, Chair, President and CEO; Billy Bastek, Executive Vice President of Merchandising; Ann-Marie Campbell, Executive Vice President of US Stores and International Operations; and Richard McPhail, Executive Vice President and Chief Financial Officer.

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

Before I turn the call over to Ted, let me remind you that today's press release and 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 Ted.

Ted Decker - *The Home Depot, Inc. - President & CEO*

Thank you, Isabel, and good morning everyone.

Over the past three years, we grew our business over $47 billion, or 43 percent. After this period of unprecedented growth, we expected demand would moderate in Fiscal 2023, which our first quarter results reflect.

Sales for the first quarter were $37.3 billion, down 4.2 percent from the same period last year. Comp sales declined 4.5 percent from the same period last year, and our U.S. stores had negative comps of 4.6 percent. Diluted earnings per share were $3.82 in the first quarter compared to $4.09 in the first quarter last year.

Our sales for the quarter were below our expectations, primarily driven by lumber deflation and unfavorable weather, particularly in our Western division, as extreme weather events in California disproportionately impacted our results.

As you will hear from Billy, where weather was favorable, we saw strength in key Spring-related categories, such as live goods and other garden categories.

As we look beyond weather and lumber deflation, our underlying performance in the quarter was mixed. We saw more pressure across the business compared to what we observed when we reported fourth quarter results a few months ago. While there was relative strength in project related categories like building materials, plumbing, and hardware, we had many departments with negative comps in the quarter and continue to see pressure in a number of big-ticket, discretionary categories. DIY customers outperformed the Pro in the quarter, but both were negative.

While internal and external surveys suggest that Pro backlogs are still healthy and elevated relative to historical norms, they are lower than they were a year ago. Additionally, recent external data points suggest that the types of projects in these backlogs are changing from large-scale remodels to smaller projects.

Though we are only one quarter into the year, we believe the underperformance this quarter relative to our expectations, lumber deflation, and continued uncertainty around underlying consumer demand, warrants a more cautious sales outlook for the remainder of the year. Richard will take you through the details in a moment, but we are now guiding to a comp sales decline between 2 and 5 percent. Reflecting this updated comp guidance, we now expect our operating margin rate to be between 14.3 and 14.0 percent, and diluted earnings-per-share to decline between 7 percent and 13 percent.

We continue to navigate a unique environment. We will remain agile and respond to evolving customer dynamics, while always being an advocate for value. In addition, we feel confident that the investments we have made in wage are driving the intended results. As Ann will discuss…in the short timeframe since our most recent wage enhancements took effect, we are attracting a greater number of qualified applicants, and attrition is down. Lastly, and as you would expect, we will continue to focus on driving productivity and efficiency across the business.

While the near-term environment is uncertain, we remain bullish on the medium-to-long term outlook for home improvement and our ability to grow share in this large and fragmented market. We look forward to sharing our perspective on the many opportunities ahead when we meet at our investor and analyst conference coming up on June 13th.

Our team continues to focus on what is most important: our associates and customers. Our merchants, store and MET teams, supplier partners, and supply chain teams did an outstanding job delivering value and service to our customers throughout the quarter. I'd like to close by thanking them for their dedication and hard work.

I'd also like to introduce Billy Bastek, who was recently named EVP of Merchandising. Billy is a 33-year veteran of The Home Depot and brings tremendous experience to the role, having spent his entire career with us in various roles of increasing responsibility throughout the merchandising organization. Not only is Billy a world-class merchant and leader, he's also a fantastic steward of our culture, and it is my pleasure to welcome him to the call today.

Billy Bastek - *The Home Depot, Inc. – EVP, Merchandising*

Thank you Ted and good morning everyone.

I want to start by also thanking all of our associates and supplier partners for their ongoing commitment to serving our customers and communities. As you heard from Ted, during the first quarter, our sales were below our expectations primarily driven by lumber deflation and unfavorable weather. We also saw a continuation of the trend we observed in the fourth quarter, with consumers pulling back on big ticket and some discretionary type purchases. However, where weather was favorable, we saw strength in smaller ticket outdoor projects.

Turning to our department comp performance for the first quarter… 4 of our 14 merchandising departments posted positive comps which were building materials, hardware, plumbing, and millwork.

During the first quarter, our comp average ticket increased 0.2 percent, and comp transactions decreased 5.0 percent. Excluding core commodities, comp average ticket was primarily impacted by inflation across several product categories as well as demand for new and innovative products.

Deflation from core commodity categories negatively impacted our average ticket growth by approximately 335 basis points during the first quarter, driven primarily by deflation in lumber. During the first quarter we saw a significant decline in lumber prices relative to a year ago. As an example, on average framing lumber was approximately $420 dollars per thousand board feet compared to approximately $1,170 dollars in the first quarter of 2022, which is a decrease of 64 percent.

Turning to total company online sales, sales leveraging our digital platforms decreased approximately 2.9 percent compared to the first quarter of last year. For those customers that chose to transact with us online during the first quarter, over 45 percent of our online orders were fulfilled through our stores.

DIY customers outperformed the Pro in the quarter, but both were negative. Pro results experienced a disproportionate impact as a result of lumber deflation, and a wet start to spring negatively impacted both customer cohorts.

Big-ticket comp transactions, or those over $1,000, were down 6.5 percent compared to the first quarter of last year. We saw some big-ticket strength across Pro heavy categories like portable power, gypsum, and pipe and fittings.

After a couple of years of unprecedented demand in the home improvement market, we continue to see softness in big ticket discretionary categories like patio, grills, and appliances that likely reflects deferral of these single item purchases and pull-forward. In addition, we have seen demand soften across other parts of the business including flooring, kitchen, and bath. This softer demand may reflect consumers moving away from larger to smaller projects.

And while there are factors impacting the home improvement market, our merchandising organization will continue to focus on being our customers advocate for value. This means continuing to provide a broad assortment of best-in-class products that are in-stock and available for our customers when they need it. We will also continue to lean into products that simplify the project, saving our customers time and money. That's why I'm so excited about the innovation we are bringing to the market whether it is.... Leviton Décora Edge, Viega Copper press fittings, or the launch of Behr Dynasty Exterior just to name a few.

At our upcoming investor conference, I look forward to sharing more about these products and some of my favorite product innovations with you in person. It is the power of our vendor relationships, coupled with our best-in-class merchant organization, that allows us to offer our customers the best brands with the most innovation to solve pain points, increase functionality or enhance performance at the best value in the market.

Now let's turn our attention to Spring. While we've had a slower start to the season, we continue to be excited about the line-up of products we have for our customers and remain ready to help them with their outdoor projects or outdoor living needs.

As you've heard us say many times – we have a great lineup of outdoor power products, and our assortment of Ryobi, Milwaukee, DeWalt and Makita offers something for everyone, building on an ecosystem of innovative tools powered by the same battery platforms…..And our live goods category looks incredible. We are ready for Spring with everything from shrubs, to a variety of flowers, herbs and vegetables for every type of gardener.

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

Ann-Marie Campbell - *The Home Depot, Inc. - EVP, U.S. Stores & International Operations*

Thanks Billy and good morning everyone.

We believe that in order to provide the best customer experience, we must focus on cultivating the best associate experience in retail. Last quarter I spoke about the investments we've made to make it easier for our associates to succeed at The Home Depot. We also announced that we would be investing approximately $1 billion in annualized compensation for our frontline, hourly associates. Today, I want to update you on key areas of improvement that we have seen thus far.

- Our ability to attract qualified pools of candidates and hire from the top tier of these pools has improved – even in our high volume stores.
- And in March we saw the greatest year-over-year improvement in our attrition rates across all associate tenure cohorts that we have seen in some time.
- As a result, we are seeing improvements in key customer service metrics, as well as benefits to our operations in the form of more consistent staffing and less safety incidents across all regions.

These improvements are exactly what we set out to achieve with this wage investment. The consistency and talent of our workforce is an important foundation for driving both customer service and productivity.

It also gives us the ability and confidence to accelerate other key initiatives that are yielding positive results with respect to customer service and productivity. We've implemented changes to our order fulfillment processes to drive speed and efficiency when picking and staging orders for customers. Historically, we allocated fulfillment hours based on overall order volume. Now we've transitioned to allocating hours more accurately based on the types of products being picked. For example, it takes less time to pick and stage a paintbrush versus a patio set. We're also grouping fulfillment orders in batches so that associates can pick multiple orders at one time.

We continue to focus on simplification. We've talked about leveraging the SideKick application to help associates prioritize the highest value tasks more effectively. Powered by machine learning, Sidekick directs associates to key bays where on-shelf availability is low or outs exist. Since Sidekick was rolled out last year, we have seen improvement in our on-shelf availability for all SKUs, but we've seen the most improvement in our high velocity SKUs, or the products that are key drivers of our business. This has translated to an increase of approximately 300 basis points in our "shelf availability" customer service score. While this app is helping us to be more efficient with our tasking activity and improving our customer experience in the process, SideKick is just getting started.

These initiatives are just a few examples of the many different types of projects that can drive significant impacts for our customers, our associates, and our shareholders.

I am so excited about all that our store teams are doing to focus on both the customer and associate experience and look forward to sharing a lot more in a few weeks. None of this would be possible without our amazing associates and I want to thank them for all they do to take care of our customers.

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

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Thank you Ann and good morning everyone.

In the first quarter, total sales were $37.3 billion dollars, a decrease of approximately $1.7 billion dollars, or 4.2 percent from last year.

During the first quarter, our total company comps were negative 4.5 percent, with comps of negative 2.5 percent in February, negative 7.5 percent in March, and negative 3.7 percent in April. Comps in the U.S. were negative 4.6 percent for the quarter, with comps of negative 2.8 percent in February, negative 7.5 percent in March, and negative 3.7 percent in April.

Our first quarter comp sales missed our own expectations, particularly in the months of March and April, driven primarily by two notable factors. First, lumber deflation drove a negative comp impact of approximately 220 basis points versus the first quarter of 2022. Second, unfavorable weather, particularly in our western division, further impacted our results.

In the first quarter, our gross margin was 33.7 percent, a decrease of 8 basis points from the first quarter last year, primarily driven by increased pressure from shrink. We continued to successfully offset supply chain and product cost pressures, while maintaining our position as the customer's advocate for value.

During the first quarter, operating expense as a percent of sales increased approximately 25 basis points to 18.8 percent compared to the first quarter of 2022. Our operating expense performance during the first quarter reflects the planned compensation increases announced during our fourth quarter 2022 call, as well as a one-time benefit from a legal settlement.

Our operating margin for the first quarter was 14.9 percent, compared to 15.2 percent in the first quarter of 2022.

Interest and other expense for the first quarter increased by $72 million to $441 million dollars, due primarily to interest on our floating rate debt as well as higher debt balances than a year ago.

In the first quarter, our effective tax rate was 24.2 percent, up from 23.9 percent in the first quarter of fiscal 2022.

Our diluted earnings per share for the first quarter were $3.82, a decrease of 6.6 percent compared to the first quarter of 2022.

During the first quarter, we opened two new stores bringing our total store count to 2,324. Retail selling square footage was approximately 241 million square feet.

At the end of the quarter, merchandise inventories were $25.4 billion dollars, essentially flat compared to the first quarter of 2022, and inventory turns were 3.9 times, down from 4.4 times last year.

Turning to capital allocation…after investing in our business and paying our dividend, it is our intent to return excess cash to shareholders in the form of share repurchases.

- During the first quarter, we invested approximately $900 million dollars back into our business in the form of capital expenditures.

- And during the quarter, we paid approximately $2.1 billion dollars in dividends to our shareholders and we returned approximately $3.0 billion dollars to shareholders in the form of share repurchases.

Computed on the average of beginning and ending long-term debt and equity for the trailing twelve months, return on invested capital was approximately 43.6 percent, down from 45.3 percent in the first quarter of fiscal 2022.

Now I will comment on our guidance for fiscal 2023.

As you may recall, last quarter we provided flat sales and comp guidance for fiscal 2023. As we mentioned last quarter, our guidance did not include potential impacts from lumber deflation, which we noted could negatively impact our performance for the quarter and the year. As a result, lumber negatively impacted comps by approximately 220 basis points in the first quarter.

Given the negative impact to the first quarter sales from lumber and weather, further softening of demand relative to our expectations, and continued uncertainty regarding consumer demand patterns, we are updating our guidance to reflect a range of potential outcomes.

- We now expect fiscal 2023 sales and comp sales to decline between 2 and 5 percent
- As a result of the change in our sales outlook, we are now targeting an operating margin between 14.3 and 14.0 percent for the year.
- Our effective tax rate is targeted at approximately 24.5 percent
- We expect interest expense of approximately $1.8 billion dollars
- And we are anticipating between a 7 and 13 percent decline in diluted earnings per share compared to fiscal 2022

As Ted mentioned, we expected 2023 to be a year of moderation in the home improvement market, driven by monetary policy actions to dampen overall consumer demand. In our view, we are in a transitional period in the consumer economy. Setting the short-term impacts of monetary policy aside, we know that the home improvement customer is healthy, and we believe the medium to long term underlying fundamentals of home improvement make it one of the most attractive markets in retail and the economy as a whole.

We believe that we are well positioned to meet the needs of our customers with a broad assortment of products, strong in-stock levels, and knowledgeable associates. The investments we've made in our business have enabled agility in our operating model. As we look forward, we will continue to prudently invest to strengthen our competitive position, leverage our scale and low-cost position to outperform our market and deliver shareholder value.

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

QUESTION AND ANSWER

Operator

[Operator Instructions] Our first question comes from the line of Chris Horvers with J.P. Morgan. Please proceed with your question.

Chris Horvers – ***JP Morgan, Analyst***

Thanks. Good morning, everybody. So my – I have two questions on the ticket side. Average ticket was flat in the first quarter. I think last year, you had same SKU inflation ex-commodity with high-single-digits all year. So how much of the ticket deceleration relative to 1Q last year was just simply same SKU disinflation on a year-over-year basis versus things like project size and trade down?

Ted Decker - ***The Home Depot, Inc. - President & CEO***

Hey, Chris. Good morning. We are still seeing inflation in same SKU items, so putting commodity aside, we gave the example of lumber being down 64%. We're still experiencing inflation in our ticket and our average unit retail, so the non-index or the non-commodity prices are still lapping cost and price from last year, and then there's still moderate inflation live this year in 2023, so inflation is still present in the average ticket.

Chris Horvers – ***JP Morgan, Analyst***

So as you look ahead, how are you thinking about how much of a headwind that becomes over the year and what did you incorporate in the guidance? And then related to that, if transactions are sort of back to 2019 levels, but in the first quarter tickets still up 37% versus the first quarter of 2019, I'm guessing maybe one-third of that is same SKU so just trying to put into context the risk around ticket in terms of disinflation and then also project size and trade down.

Ted Decker - ***The Home Depot, Inc. - President & CEO***

Right. Well, it's something we clearly look at carefully. There certainly has been a lot of cumulative inflation in price in our average unit retail, in our ticket but that is not something that we are expecting to broadly deflate.

Now commodity prices, those price essentially weekly and we will price those up or down on a weekly basis, but price levels in a number of our products have increased and been established over the past three years and embedded in that higher ticket is innovation.

So when you think of ticket, a lot of that is not just cost and price. It's trading up to better product. When you think of battery-powered outdoor power equipment, what we've done in the paint department with better and better paints. There's innovation, and with innovation it's usually higher price-points, so we don't see those deflating broadly as we work through this period of moderation.

Chris Horvers – ***JP Morgan, Analyst***

I guess, just in terms of, do you think – if you sort of look at the trend on project size, does that become, will that cause ticket to become negative over the years? Is that how you're thinking about it?

Ted Decker - ***The Home Depot, Inc. - President & CEO***

I wouldn't say over the years. Certainly, right now, we are seeing two of the biggest factors on each ticket and transaction is as we've said, we have specific discretionary items, best examples are things like a grill, a patio set and appliances tend to be one-off discretionary items and we are seeing pressure in those.

We've been seeing pressure in those for some time. What was newer in our observations this quarter is that while projects are still strong and Pro project backlog is still elevated, the size of the projects are getting a bit smaller, and it could be that the projects being deferred or it could be that the project is being broken up into chunks. So rather than do an entire room or an entire basement, you start working away at it in smaller chunks and that clearly impacts items per-basket and overall activity.

Chris Horvers – ***JP Morgan, Analyst***

Got it. Thank you very much.

Operator

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

Steve Zaccone – ***Citi, Analyst***

Great. Good morning. Thanks for taking my question. I was hoping you could comment a bit on what you're seeing in the second quarter to-date. Just given the fact that weather has been so volatile across the US and then just in the context of that, how should we think about second quarter maybe versus the back half of the year? What can kind of get you to the high end versus the low end of your full year guidance range?

Richard McPhail - ***The Home Depot, Inc. - EVP & CFO***

Sure. Well, thank you, Steven. So the first two weeks of May are in line with the guidance we've provided. We don't break out quarterly guidance, but the two first – the first two weeks are consistent with the guidance that we provided. We're going to learn a lot over the next few weeks with respect to underlying demand, as we still have some of our largest selling weeks ahead of us.

If you think about what our guide implies from a shape of the year, first let's perhaps talk about the building blocks of our range, so how we got to the negative 2% to the negative 5% and then we'll talk about the shape of the year. The negative 2% was really built on flowing through the Q1 performance, adding the Q1 lumber impact in the guidance, adding a little further lumber pressure that we'll see in Q2. We think that there could be 120 basis points of comp pressure in Q2, based on current lumber price, and then that negative 2% scenario also reflects our share of PCE which shifted at a more accelerated rate than expected in the first quarter, sort of holding at that rate for the rest of the year. So, those are the underlying assumptions in the negative 2%.

The negative 5% case, simply takes that PCE share shift assumption. Our share of PCE and assumes that we revert back to 2019 levels of PCE share by the end of the fiscal year, so that would imply the negative 5% case. When we talk about the shape of the year, now for the negative 2% high-end of the range, we would expect that the second half would be better than the first half really due to lumber normalization in the second half on a year-over-year basis. The vast majority of lumber pressure year-over-year exists in that first half, so as that normalizes in the negative 2% case second half improves versus the first half.

In the lower end of our range, we would expect the first half would outperform the second half. Again, due to that assumption of continued acceleration in our share of PCE.

Steve Zaccone – ***Citi, Analyst***

Great. Thanks for all the detail on that. And then I wanted to follow-up on the comment about this being a transitional period for the consumer. In the context of the question is how do you think about this year as the potential trough in demand for home improvement versus it potentially being a multiyear trend and maybe 2024 is another step-down? And I know, you'll have – there's a lot of moving pieces and you'll have an Analyst Day in a month, but if you could comment on that at all it would be helpful.

Ted Decker - ***The Home Depot, Inc. - President & CEO***

Yeah, why don't I just take it up a bit on the consumer and their health and then their engagement in home improvement. If you look at the consumer overall, they're still relatively strong as evidenced by continued increases in personal consumption and then when you look at our customer and we have one of the best customer sets in any market sector. Our customer is stronger than the overall consumer when you think they tend to have good jobs, increasing wages and own their homes, and collectively those home values have increased by about $15 trillion since 2019, so as we said, we grew disproportionately these past few years, $47 billion in growth, 43% cumulative comp and as consumers shifted their spending, as these healthier consumers shifted their spending into home improvement and undoubtedly after that period of growth, you're going to see moderation which is exactly what we saw in Q1.

So, when you think about what this reflects about the consumer in the future engagement in home improvement, you think about a few things. We've seen an accelerated shift out of goods to service spending as the broader economy has gotten back to normal and that's in particular in home improvement. Obviously, people aren't spending all their time at home as they did in the prior few years.

And then there's an impact of pull-forward or deferral of certain categories like I spoke about earlier, appliances, patio, grills that saw outsized growth in the early years of the pandemic and then a newer dynamic now that we're really seeing again this – just this past quarter is a more cautious consumer given the broader macro concerns including credit availability, and that aligns with what we're observing in our business and the comments I made about our Pros, and consumers taking on smaller less discretionary projects.

Then lastly with the build-up of inflation that we've seen, there's certainly some price-sensitivity, particularly with respect to those bigger ticket discretionary items. So, in general, our homeowner consumer is – remains very healthy. It's a matter of digesting the outsized growth in shift of consumption spend out of services into goods and particularly into home improvement, so we'll get to this period. Richard's talked about the PCE normalization. We don't know where that ends or how quickly it goes. There's an argument that PCE and home improvement stays elevated, all the reasons we've talked about before.

The home values are so much higher. The age of the home is considerably older on average. People are spending more time at home, so all those dynamics could suggest normalization might be in fact a higher-level of PCE spending in our sector but regardless of all that, we'll get through this transition period, and we remain incredibly bullish on the health of this sector. It's one of the absolute best sectors in all of retail. It's a large and fragmented market and we have tremendous growth opportunities going forward.

Steve Zaccone – *Citi, Analyst*

Thanks for all the detail. Best of luck for the remainder of spring.

Operator

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

Zack Fadem - *Wells Fargo, Analyst*

Hey. Good morning. Can you help us bridge the gap from the 15.3% EBIT margin last year to the 14% to 14.3% today? And specifically, how should we think about the moving parts around gross margin versus SG&A? And then specifically for Q1, cost controls were a bit better-than-expected. Can you talk us through the impact of the legal settlement and anything else you'd highlight there?

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Yes, Zack. Thank you for the question. So, let's first walk from 15.3%, which is our actual operating margin in 2022 to our original guide of [ph] 14.5% margin (00:35:32). At a flat comp, particularly in an inflationary environment, our business will see a degree of deleverage in expenses and so there's really three factors. Natural deleverage in the business, a $1 billion investment in wage which has proven to, as Ann said, provide real benefit from a customer experience point of view, and then, productivity initiatives designed to offset some of that deleverage, and so when you net all those three against each other, that lead to our guide of 14.5% of flat comp.

As we reflect on the revision to guidance, the range of operating margin that we have guided toward reflects the natural operating margin at these negative comp levels. In other words, there is – there are levers that help blunt deleverage, but there is deleverage still in our model. The greatest mitigator is that we have an activity-based payroll model, and so as activity in our stores decreases, so does our lever – sorry, our level of payroll so you do have a natural buffer there, but again the 14.3% to the 14.0% would be the natural operating margin at the negative 2% and the negative 5%.

When we think about the one-time legal settlement, so we did realize a large one-time benefit from a legal settlement, our guidance assumes this benefit will be offset during the remainder of the year and so that's just a simplified assumption. We will protect that 14% operating margin. We'd agree with – operate with a degree of financial flexibility, and as the year progresses, we'll be evaluating the levers available to us against the backdrop of the environment.

Zack Fadem - *Wells Fargo, Analyst*

Got it. Appreciate the color. I've got a big picture question. Could you talk about the macro and housing indicators that you believe are now most correlated to your business today? And then considering the golden handcuffs of sub-3% mortgages out there, do you think this takes longer now for housing turnover to materially recover?

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Well, I'll take the second one first. We've already seen the impact to housing turnover. I think that we've probably fully seen the impact of higher mortgage rates on potential sellers. In this environment, if you have a low fixed rate mortgage and let's just remind ourselves, 40% of owner occupied homes are owned outright, and of the households that hold the mortgage, close to 90% of those hold fixed rate mortgages under 5%, so with mortgage rates where they are today, there's a reluctance to sell your home, and there is a greater incentive to stay in place and improve in place. And as Ted said, you're spending more time at home and that home is getting older, and you do not have an incentive to sell and take on a higher-rate mortgage, so I think we've already seen that in housing turnover.

With respect to macro indicators, I think as Ted said, I think what we're seeing in the business now is reflective of the broader impact of tighter monetary policy and tighter credit conditions. You know what's interesting is we saw the quarter unfold, if you look at how we did during February, our business was actually trending quite positively. In fact, February's dollar run rate adjusted for normal seasonal curves would have implied a positive comp for the year.

You think about March. Well first of all, March was impacted by extreme weather. Most notably in California and that was also the point where we saw accelerating share shift. There were some external factors there that maybe don't have direct influence, but as you know, in March, we saw the collapse of SVB and you think about the tighter credit conditions that were a result of the external environment.

We think all of those just build to a broader caution among consumers. As Ted said, our homeowner customer is extremely healthy. Very healthy balance sheet, healthy income. This is a broader consumer economy dynamic we think we're seeing.

Zack Fadem - *Wells Fargo, Analyst*

Thanks, Richard. Appreciate all the color.

Operator

Our next question comes from the line of Michael Lasser with UBS. Please proceed with your question.

Michael Lasser - *UBS, Analyst*

Good morning. Thanks a lot for taking my question. As you look across your entire assortment and trying to set current unit demand versus what would be a normalized rate, how many product categories are still well-above what would be suggested by a normalized rate perhaps, if you look at appliances, grills, and patio furniture and where units are today versus 2019, and expand that math to the rest of the business, what would that suggest about a downside comp scenario even from here?

Ted Decker - *The Home Depot, Inc. - President & CEO*

Michael, great question. I wouldn't say we've gone into that level of detail by category. Certainly, a number of those categories were elevated. The ones you called out, patio, grills, appliances were elevated on retails with innovation as well as units with outsized demand. I think when you think of normal replacement cycles and pull-forward on some of that product, that's just going to take a little bit of time to normalize.

Other categories that we haven't talked so much about that are really booming, frankly, are categories like building materials, where we're seeing unit volume still running quite strong. We see units in lumber picking up meaningfully as prices come down, you get attachment with building materials, and then hardware, which attaches to both building materials and lumber, we're seeing our strongest hardware unit productivity and attach rate to those project starter categories.

I think, Billy, it's the highest attach rate we've ever recorded.

Billy Bastek - ***The Home Depot, Inc. – EVP, Merchandising***

Yeah, that's right. Think about our building materials performance, we called that out as an outperform, along with lumber, still seeing great unit productivity across those businesses, and seeing the attach smaller – certainly smaller projects taking place, and then Ted did mention some of the – we did see some pull-forward in some of those businesses that we talked about initially as well.

Michael Lasser - ***UBS, Analyst***

My follow-up question is if we consider 2023 to be the transition year, and comp for The Home Depot do return to growth in 2024, would you start seeing leverage on your expenses on the first dollar of growth or will there be some catch up like, Richard, you mentioned the legal expense you expect to give back some of that over the course of this year, presumably there will be an incentive comp benefit as you lowered your guidance, so will you see some of those items come back next year, such that if we have in our models a positive comp, we wouldn't necessarily expect you to leverage your expenses on the first dollar of growth next year?

Ted Decker - ***The Home Depot, Inc. - President & CEO***

Well, we'll get into a bit more detail on outlook in 2024 when we get together in June for the investor conference. We're not modeling 2024 to that level of specificity as we're only a few months into 2023, but broadly, Michael, our model is meant to leverage and will leverage with volume, and we have some costs to take out of the business for sure. You think on the product side with transportation in particular, you'll see significant costs come out as we work through our current inventory levels with higher transportation rates experienced during COVID, and then on the operating model, the store and labor, that will always leverage with growth.

Richard McPhail - ***The Home Depot, Inc. - EVP & CFO***

And obviously, we manage cost and price independently, Michael, and transportation costs are a market dynamic, and so we'll make sure that we're positioned as the customers advocate for value with respect to price, but as Ted said, we'll get more into this in 2023. Or sorry, in June 13.

Michael Lasser - ***UBS, Analyst***

Richard, can I just clarify what that comment is intended to state, because one of the debates is costs have come down, whether transportation costs, certain raw materials, so there's a question of whether that means there's going to be like-for-like product deflation in non-commodity-related areas over the course of this year, and it sounds like Home Depot is going to continue to be an advocate for growth but how would you clarify that – for advocate for value? Sorry.

Richard McPhail - ***The Home Depot, Inc. - EVP & CFO***

Right. No, again, we manage cost and price independently. As Ted said, we don't expect broad-based deflation in this market.

Operator

Our next question comes from the line of Brian Nagel with Oppenheimer. Please proceed with your question.

Brian Nagel - *Oppenheimer, Analyst*

My first question and I know we've discussed it a bit already but the weather. I was just wondering if you could go into a little more detail, what you saw kind of the spread between – in comps between markets where weather was an issue, in markets where weather may have been more normal. And then as – looking at more data, the spring has come – has arrived in a lot of markets, so what are you seeing then as far as any type of pickup in seasonal categories as the spring-like conditions are starting to take hold?

Ted Decker - *The Home Depot, Inc. - President & CEO*

Yeah, Brian, thank you. So weather as we said was most pronounced in the West, and very unique weather pattern. This wasn't a bad weekend. This was record rain and even things like snow in Southern California, so where weather was sustained and bad, when we look at the West versus our Northern and Southern divisions, the impact was a multiple of what we saw in the other parts of the country.

And generally, we talked in the past about the bathtub effect and we wouldn't have updated guidance based on stronger or relatively weaker sales in Q1 based on weather, because we would look to get that back, so when you think of a shorter spring season in the North where people are going to get that activity done in a limited number of weeks, if you don't get it done in the first quarter, people tend to make it up in the second quarter.

The dynamic in the West and this went into our guidance of the minus 2% to minus 5%, is the West, it's more level weather patterns. We have very large stores, very high Pro concentration, and when you get bad weather, you're not really looking at a bathtub effect to make it up in a short season. You just sort of miss that selling week, so the difference geographically was pronounced in the West, and we just look at that as sort of lost selling weeks.

In the North, the behavior is more typical to the bathtub. We didn't have many good weekends but when we did, sales were incredibly strong, so we're certainly hoping for better weather in Q2.

Brian Nagel - *Oppenheimer, Analyst*

Okay. That's helpful. And then – very helpful and then my second question, again recognizing there's lots of moving parts here and you're dealing with varied comparisons through the year, but as you look at – as you think about or as you – the updated guidance for 2023 you gave us today. Does that basically assume kind of the continuation of what we've seen so far in 2023 or are you assuming some type of either improvement, further deterioration, et cetera, through the year?

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

That's right. Brian, that's why we gave the range. I mean, you would say that particularly the bottom-end of the range would assume greater deceleration than we've observed to-date, and if consistent with the hypothetical case we laid out at the beginning of the year, which was to say look if our share of PCE reverts to 2019 levels by the end of the year, that is what you would see, and again, that would be an accelerated rate of reversion versus what we've seen.

So the negative 2%, again, sort of has, it takes into account the fact that we saw sharper reversion than expected in Q1 and that we would hold that share through the end of the year. It's not a perfect science and that's why we gave you a range.

Brian Nagel - *Oppenheimer, Analyst*

I appreciate it. Thank you.

Operator

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

Scot Ciccarelli - *Truist, Analyst*

Good morning, guys. So, Richard, you talked about protecting a 14% operating margin, even with the wage investments that you guys have made this year at this point. What other – I mean, how much flexibility do you think you have on the SG&A line because I know labor is your biggest kind of plus bucket, but you're actually investing more in labor not less, so how should we think about how you guys are managing that component?

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Well, the investment in wage, again, which has really proven to have driven a lot of benefit on the customer experience side, that's embedded in our guidance. We've made the investment and that will be roughly a $1 billion addition to our cost structure, but it's embedded in our margin structure.

Again, as the year progresses, we'll be evaluating levers available to us against the backdrop of the environment. We invest to win over the long term. We're comfortable with our levels of investment as it stands today. We'll continue to assess our investments against the backdrop of the environment and we have some flexibility there too.

Scot Ciccarelli - *Truist, Analyst*

And just a quick follow-up. With higher interest rates in the marketplace, does that change how you guys are thinking about capital allocation not necessarily from a strategic basis but how aggressive do you want to be in terms of issuing debt to buy back stock? Thanks.

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

We feel good about where we stand from a debt-to-EBITDAR perspective. We have a maturity, $1 billion maturity in April and we repaid that. Didn't refinance it. We have no need necessarily to go to the debt capital markets in the short-term, and we'll watch market conditions as they unfold. But we feel good about where we are from a leverage perspective.

Operator

Our next question comes from the line of Brad Thomas with KeyBanc. Please proceed with your question.

Brad Thomas - Keybanc, *Analyst*

Hi. Thanks for taking my question. Was hoping we could talk a little bit more about the trends you've been seeing in the Pro business. I think, this is the first time in a few quarters that it had underperformed DIY. What are you seeing out of the Pro? Has it improved as the weather has gotten better and how are you thinking about it going forward?

Ted Decker - *The Home Depot, Inc. - President & CEO*

Yeah, I'll let Hector talk a bit about the Pro and what we like that we're seeing, but from the broadest perspective, don't forget the Pro was disproportionately impacted by lumber and then again a very strong Pro business out West, but we like what we're seeing with our customers as they engage with our capabilities.

Hector Padilla - *The Home Depot, Inc. – EVP, Outside Sales & Service*

Yeah, good morning, Brad. This is Hector. On a two-year basis, our performance was positive and as Ted just mentioned and Billy, we saw that disproportionate impact from lumber and weather. What we're most excited about is what we're seeing with our Pros who are engaging with our new supply chain assets and expanded Pro capabilities that we have talked about in the past. We're getting share of wallet with them and as they're growing they spend with us, they have a willingness to consolidate their purchases with The Home Depot. They love our brand, they love our assortment and our value proposition and we're seeing that across many markets. I really look forward to speaking with you in more detail in June about how the Pro business is doing and around the capabilities that we're building.

Brad Thomas - Keybanc, *Analyst*

Great. And as a quick follow-up, obviously, some moving pieces here with weather and deflation. I believe your prior outlook for the home improvement market was a decline of low single-digits. What are you assuming in your new outlook?

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

So we began the year with a flat outlook for PCE. There are economists who have lifted that outlook slightly for PCE, but as we observe, PCE share that our market holds, and the shifts that we've seen, we expect our market to be down mid-to-high single-digits and so implicit in our guide is the expectation that we'll continue to take share.

Brad Thomas - Keybanc, *Analyst*

Great. Thanks so much.

Operator

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

Simeon Gutman - ***Morgan Stanley, Analyst***

Hey. Thanks. Good morning, everyone. I want to ask about home prices. There's been a case that's made that demands decoupled a bit from turnover and that prices could matter more. I want to ask specifically about how that could inform the cadence of the year, because if you are a strict adherent to prices the lag effect could suggest that the back half core gets a little bit worse. I'm curious how you think about that.

Ted Decker - ***The Home Depot, Inc. - President & CEO***

Well, of all the housing metrics, Simeon, we think home value has the tightest correlation to home improvement spend. Certainly, turnover and household formation also are influence to spend, and there's generally a lag effect as you say to home price appreciation or depreciation.

I think the difference here is how sensitive are people going to be that I was up 45% in home value from the end of 2019, and, yes, now month-over-month, the values are off slightly, but I'm still up 40% or 38% from where I was at the end of 2019. That psychology is tough to weed out with the general consumer apprehension given general inflation in macro and rising interest rates and all the talk, are we going to have a recession, are we not going to have a recession, so I wouldn't think that that would have that big of an impact. We're not thinking that's a big impact in 2H.

Simeon Gutman - ***Morgan Stanley, Analyst***

Okay. That's fair. One more question around the updated guide for Richard. The midpoint of this negative 2% to negative 5%, just to clarify. That assumes that the core worsens from Q1 as well as the impact of lumber worsens from Q1?

Richard McPhail - ***The Home Depot, Inc. - EVP & CFO***

You can think of the impact of lumber being kind of an assumption that is equal across all cases so about 120 basis points of pressure to Q2 and then very slightly non-meaningful pressure in the second half, and again, we've given a range, Simeon, to just provide sort of a balanced view here. It's tough to extrapolate this early in the year, and so we feel like the range approach is the most helpful guidance that we can give.

Simeon Gutman - ***Morgan Stanley, Analyst***

Right. Okay. Thank you.

Operator

Our next question comes from the line of Seth Sigman with Barclays. Please proceed with your question.

Seth Sigman - ***Barclays, Analyst***

Hey, everybody. Good morning. I wanted to follow-up on that assumption that home improvement wallet share will normalize back to 2019 levels, and obviously that implies things get worse from here, but I guess there's also been some prior cycles where wallet share overshoots on the downside and goes lower than where it was before, and we talked a lot about pull-forward already today, but how do you think about that scenario and why that scenario would be wrong this time?

Ted Decker - *The Home Depot, Inc. - President & CEO*

Well, as we've said, we've given the guide for our best view of 2023 and the downside of a minus 5% would be that you've reverted by the end of the year to 2019 levels, so mathematically, you could say well there'd be some hangover of that into 2024, and then your question, does it over shoot?

Frankly, we don't know. As I said earlier, there's as strong a case if not stronger that where you settle is a higher share. If based nothing more than your asset class is so much higher. I mean, we're not talking billions of dollars, we're literally talking trillions of dollars that this asset class has more value, so if you're thinking about percent of investment in any asset class, you've got a much bigger base.

We talk about the average age of the home is now over 40 years old, and we have big chunks of homes that are reaching that 20-year and 40-year sort of witching hour of age. We all know we're spending more time at home, so wear and tear is higher, so we've talked about all these dynamics in the past, and I'd say if you had to call it, you would say the spend would ultimately settle out potentially higher.

Seth Sigman - *Barclays, Analyst*

Okay. Fair enough. Just want to follow-up on the EBIT margin guidance for this year. I think what you laid out here at the low end, so 14% margin on negative mid single-digit comps. Very consistent with the scenario as you talked about last quarter, but it does include that Q1 SG&A benefit. Can you just help us better understand. Does that imply the underlying is actually lower? I think, you may have said there's an offset to that. Maybe you can just clarify that point? Thank you.

Richard McPhail - *The Home Depot, Inc. - EVP & CFO*

Thanks for the question. To clarify it's not assuming that the underlying would be lower. Our guide actually assumes that that gain would be offset through the remainder of the year.

Seth Sigman - *Barclays, Analyst*

Okay. Thanks very much.

Isabel Janci - *The Home Depot, Inc. - VP, IR & Treasurer*

Christine, we have time for one more question.

Operator

Thank you. Our final question comes from the line of Steve Forbes with Guggenheim. Please proceed with your question.

Steven Forbes - *Guggenheim, Analyst*

Good morning. Just wanted to follow-up on lumber trends. You made a commented about price deflation. Curious if you could talk about what specifically happened with unit volume during the quarter, and then what the guidance assumes in the back half as the price compares ease in terms of unit expectations right in the second half?

Billy Bastek - ***The Home Depot, Inc. – EVP, Merchandising***

Yeah, thanks, Steven. This is Billy. As we talked about, Richard mentioned in his previous comments, we do anticipate the greatest pressure from lumber in the first half. For the total year, we think lumber deflation impact to the comp is about 100 basis points. Now, with that we're seeing strong unit movement across plywood, dimensional lumber, PT decking. It's 220 basis points as we mentioned in Q1. Another 120 basis points roughly in Q2, which is in the guide and then we don't expect a material impact from lumber for the back half of the year, but still seeing really strong unit performance in the categories I called out.

Steven Forbes - ***Guggenheim, Analyst***

And so, maybe just – so, you do expect unit volume to improve in the back half or what is sort of the trajectory of unit dynamics right with lumber specifically implied in the guide?

Billy Bastek - ***The Home Depot, Inc. – EVP, Merchandising***

Well, as the pricing normalizes year-over-year you'll see the units reflect in that as we get towards a more rational state that we had in the back half of last year.

Steven Forbes - ***Guggenheim, Analyst***

And then just a quick follow-up. Any sort of preview of what we should expect at the upcoming Analyst Day? I think, you made a comment before potentially about speaking to 2024, but I wasn't sure if you could maybe clarify any sort of preview thoughts on what we should expect to hear at the Analyst Day.

Isabel Janci - ***The Home Depot, Inc. - VP, IR & Treasurer***

Thanks for that question, Steve. I think what you'll hear us talk about is the updated TAM that we will lay out for you. Our growth opportunities to go after that TAM and a little bit more about why we're so excited about the sector and the business.

Steven Forbes - ***Guggenheim, Analyst***

Thank you.

Operator

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

Isabel Janci - ***The Home Depot, Inc. - VP, IR & Treasurer***

Thanks, Christine. And thanks everybody for joining us today. We look forward to speaking with you at our Investor Conference on June 13.

Operator

Ladies and gentlemen, this does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.