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LOW.N - Q3 2023 Lowe's Companies Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 21, 2023 / 2:00PM GMT

OVERVIEW:

Company Summary

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PRESENTATION

Operator

Good morning, everyone, and welcome to Lowe's Companies Third Quarter 2023 Earnings Conference Call. My name is Rob, and I'll be your operator for today's call. As a reminder, this conference is being recorded.

I will now turn the call over to Kate Pearlman, Vice President of Investor Relations and Treasurer.

Kate Pearlman - *Lowe's Companies, Inc. - VP of IR*

Thank you, and good morning. Here with me today are Marvin Ellison, Chairman and Chief Executive Officer; Bill Boltz, our Executive Vice President, Merchandising; Joe McFarland, our Executive Vice President, Stores; and Brandon Sink, our Executive Vice President and Chief Financial Officer.

I would like to remind you that our notice regarding forward-looking statements is included in our press release this morning, which can be found on Lowe's Investor Relations. During this call, we will be making comments that are forward-looking, including our expectations for fiscal 2023. Actual results may differ materially from those expressed or implied as a result of various risks, uncertainties and important factors, including those discussed in the risk factors, MD&A and other sections of our annual report on Form 10-K and our other SEC filings. Additionally, we'll be discussing certain non-GAAP financial measures. A reconciliation of these items to U.S. GAAP can be found in the quarterly earnings section of our Investor Relations website.

Now I'll turn the call over to Marvin.

Marvin R. Ellison - *Lowe's Companies, Inc. - President, CEO & Chairman*

Thank you, Kate, and good morning, everyone. For the third quarter comparable sales declined 7.4%. Our results were driven by a greater-than-expected pullback in DIY discretionary spending, especially in bigger ticket categories. While we've seen a more cautious consumer

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for some time now, this quarter, we saw some of these consumers increasingly prioritizing experiences over goods spending on travel and entertainment.

As a reminder, at Lowe's, 75% of our revenue is driven by DIY customers and 25% by Pros, while the broader market mix is roughly 50% DIY and 50% Pro. As a result, whenever the DIY customer becomes cautious, it disproportionately affects us. And while we face a softer DIY demand in the third quarter, I'm pleased that at the same time, we once again delivered positive sales comp in Pro.

Now I'd like to take a moment to dig a bit deeper into our DIY performance for the third quarter. In categories like appliances, decor, flooring and kitchen and bath, where we have strong DIY penetration, we saw increased pressure on sales of bigger ticket purchases like appliances where consumers are postponing purchases if they can. For example, customers may have previously bought an entire kitchen suite may now just buy a refrigerator. Keep in mind that the industry-wide pullback in appliance sales has a larger impact on Lowe's since we are the market leader in appliances in the U.S. with 14% of our sales coming from this category. Later in the call, Bill will discuss some of the initiatives we're implementing in Q4 to improve DIY performance with a more targeted effort to reach value-conscious customers including our most competitive offers on single unit appliance purchases ahead of the holiday season and the launch of our Lowe's lowest price guarantee, so our customers can shop with confidence knowing that they'll always find the best price at Lowe's.

Despite the pullback in DIY, our Pros are still working and many of their projects are a result of increased wear and tear on aging homes, which lead to unavoidable repairs. This continues to create project backlogs for small to medium sized Pro, who is our core customer. In our most recent survey, nearly 70% of Pros reported healthy project backlogs, but given the uncertain macro environment, they're feeling a little less confident. Although Pros may be a bit cautious in this environment, our ability to deliver a positive pro sales comp in the third quarter is a reflection that our strategy is working.

We're making progress with the investments we've made over the last several years to improve our service offering, including increasing loyalty through our MVP Pro rewards, developing a world-class CRM platform, improving job site delivery, enhancing service levels in our stores, creating a more seamless online experience and a number of merchandising initiatives that Bill will discuss later in the call. Overall, we built a competitive pro sales and service model, which is creating a flywheel effect that will enable us to grow Pro sales at 2x the pace of the market.

Let's now turn to online sales, which declined 4% in the quarter as the same pressures in DIY bigger ticket categories impacted digital sales.

Now let's talk about what we're doing to manage this unique environment. In store operations, we've made foundational improvements to associate productivity that enable us to effectively align labor to demand while continuing to serve our customers. During the quarter, we leveraged these new capabilities to reduce operating expenses while enhancing the customer experience for both Pro and DIY customers at the same time. Joe will provide more detail on these initiatives and our improved customer service scores later in the call. I'm pleased that our disciplined focus on expense management across the organization contributed to a 46 basis point increase in operating margin rate compared to adjusted operating margin in the prior year despite the sales decline, which led to diluted earnings per share of \$3.06.

As we explore ways to drive improved sales with our DIY customers, I'd like to provide you with an update on two initiatives, our new Lowe's outlet stores and our rural strategy. Let me start with our Lowe's Outlet stores. We opened our 15th Lowe's outlet location in Q3. With these smaller format stores, we can leverage lower cost real estate in trade areas closest to our core customer without cannibalizing a nearby Lowe's store. In an environment where DIY consumers are seeking value, we're pleased with the customer response and the overall performance of our outlet locations. These stores complement our market delivery network, allowing us to offer savings between 25% to 70% off on big and bulky scratch and dent items like appliances, patio furniture, grills, all while maximizing profitability and offering our customers enhanced value. We look forward to discussing the potential growth opportunities of this strategy on an upcoming call.

Turning to our rural strategy. This one-stop shop concept is designed to give customers located in rural areas across the country, everything they need for their home and farm, including a wide offering of farm, ranch and outdoor products. During the summer, we launched this rural assortment to over 300 stores where we're selling products like livestock feed, pet food, utility vehicles and apparel from brands like Carhartt and Wrangler. These programs include a Petco store within a store, which enhances the total home solution we offer by bringing together home improvement and pet care services, products and expertise under one roof.

We're pleased to see this new initiative already gaining traction with strong performance in pet, apparel and automotive. In fact, these rural customers are our best-performing DIY segment and these stores are performing significantly above the company average. Given this initial success, we're now exploring expanding this rural assortment beyond the original 300 designated rule stores. In addition, we're planning to add incremental merchandising initiatives within these original 300 stores because the customer is responding favorably to these new assortments and product lines.

Looking ahead, we remain focused on our merchandising and marketing efforts that highlight the everyday value at Lowe's for our price-sensitive customers. And we will continue to invest in our strategic growth initiatives within our Total Home strategy as we strive to become a world-class omnichannel retailer.

And as I wrap up, let me say that we remain bullish on the medium to long-term outlook for the home improvement industry, supported by favorable housing and demographic trends. We expect home prices to be supported by a persistent supply/demand imbalance of housing, while at the same time, 250,000 millennial household formations are expected per year through 2025, and their parents and grandparents, the baby boomers increasingly prefer to age in place in their own homes. And we cannot overlook the fact that we now have the oldest housing stock in U.S. history with the median age of homes now 41 years old, which will need ongoing investments in repair and remodel projects. These factors continue to reinforce our optimism about the mid to long-term outlook for our industry.

In closing, I'd like to thank our frontline associates with our continued hard work and dedication to serving customers and our communities.

And with that, I'll turn the call over to Bill.

William P. Boltz - Lowe's Companies, Inc. - EVP of Merchandising

Thanks, Marvin, and good morning, everyone.

Despite a pullback in DIY discretionary demand, we are pleased that we delivered positive Pro comps this quarter as our enhanced product and brand offerings continue to resonate with the Pro. Over the past several years, we've added the brands that Pros want, and we have invested in the inventory quantities Pros need, and we continue to tailor our product assortments to local building codes and preferences. These investments continue to pay off even in a more challenging macro environment, where we remain laser-focused on highlighting everyday value and convenience, both in our stores and online to a price-conscious consumer.

Turning to our results in Building Products. We continue to serve our Resilient Pro customer who remains active, especially on repair and maintenance projects. We delivered positive comps in building materials, partly driven by strong performance in Pro-heavy categories like roofing and drywall. We also delivered comps above the company average in rough plumbing, largely driven by positive comps in water heaters demonstrating that Lowe's is the go-to solution for critical repair needs. This quarter, Klein Tools returned home to Lowe's. This trusted brand is the #1 tool brand for electrical and HVAC professionals, and we are thrilled to now offer the largest assortment of Klein Tools in the home improvement retail channel. Our Pro customers' response to our relaunch of Klein tools has exceeded our expectations, and we're excited about our plans to expand this iconic brand to support the unique needs of these trade professionals.

Now let's shift gears to home decor, which was most heavily impacted by lower DIY project-related demand. And as you heard from Marvin, this had a greater impact in categories like appliances, flooring and kitchens and bath. Within appliances, we are seeing lower industry unit volumes as well as the reintroduction of pre-pandemic levels of vendor-funded promotion, which puts pressure on average selling price. And while our results in kitchens and bath were also impacted by softer DIY demand. We are seeing our private brand products gaining traction as the consumer continues to look for value, like with our new allen + roth butcher block countertops. These are made of solid FSC-certified wood and this stylish product is a cost-effective way to refresh your kitchen, bar or studio. This item has been so popular that we are now doubling our sales expectations.

Turning to paint. We delivered comps above company average in the quarter, largely driven by the Pro who paints, who relies on Lowe's as a one-stop shop for their project needs. We continue to look for opportunities to expand our product offering, including a recent launch of an

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exclusive line of Sherwin-Williams primers from HGTV Home. These new primers designed for the Pro who paints, gives them a versatile multi-surface application that makes it easier to work on both interior and exterior projects.

Shifting gears to hardlines. In addition to a broad-based DIY pullback, we also saw pressure in categories impacted by storm-related activity, such as generators, gas cans, fuel and chain saws as we cycled Hurricane Ian from last year. We delivered comps above company average in lawn and garden as our customers engaged in smaller fall cleanup projects. And we also drove comps above company average in hardware led by key Pro categories like fasteners, safety equipment and cleaning products.

Lastly, we continue to build out our brand portfolio like with our new strategic partnership with the Toro Company. Their exciting product lineup further complements what is now the strongest brand offering in outdoor power equipment, one that resonates with both the Pro and DIY customer who relies on Lowe's to offer the best selection. We're looking forward to launching Toro ahead of our upcoming spring season and building on our momentum as the leading retailer of outdoor power equipment.

In response to the customers' increased focus on value, I'd like to talk about how we are highlighting some of the ways that customers can save time and money during this holiday season. For starters, we recently kicked off our holiday campaign with a commitment to supporting shoppers in new ways, all season long, which includes a wave of exciting offers and new deals every week, on great gift ideas, including power tools from some of the best brands like DEWALT, Craftsman and Kobalt and pre-lit Christmas trees, trimmed with the innovative energy-saving LED lighting. Our customers can also look forward to same-day delivery on key holiday and home improvement items as well as services like holiday light hanging for the home through Angi.

And as Marvin mentioned, we recently launched our new Lowe's Lowest Price Guarantee to remind customers that not only can they expect a great shopping experience, but they will also receive the lowest price on items for their home. In fact, Customers can now find our lowest prices of the year on select major appliances. And in an effort to simplify the offer and make it easier to understand, we're offering \$100 off for every \$800 a customer spends. For our Pros, we have tailored exclusive bulk saving offers on appliances as well and to drive even greater excitement and traffic on Black Friday, we will feature more than 10 major appliance doorbusters. We are excited to deliver what we think will be the most compelling offers in the market.

In addition to these great deals, Lowe's is now offering Carhartt apparel online and in select stores. This iconic workwear brand makes a perfect gift for the Pro this holiday.

Before I close, I'd like to highlight just a few of the perpetual productivity improvements or PPI work streams that are underway in merchandising. Our teams continue to make progress in our three main focus areas: product cost management, inventory productivity and pricing and promotional strategies.

We continue to partner with our suppliers to take cost out, especially now that transportation and commodity costs have come down. And we are expanding our private brand portfolio, which delivers great quality and value at a lower price to our customers, while also driving better margin rate productivity. Our teams are working hard to ensure that customers have the best value every day at Lowe's, while also delivering productivity for the organization.

And as I close, I'd like to extend my appreciation once again to our vendors and our merchants for their hard work, dedication and ongoing partnership.

Thank you, and I'll now turn the call over to Joe.

Joseph Michael McFarland - Lowe's Companies, Inc. - EVP of Stores

Thank you, Bill, and good morning, everyone. I'd like to begin by thanking our frontline associates for their ongoing efforts to deliver excellent customer service. As Marvin mentioned, we were able to reduce operating expenses this quarter, while at the same time delivering a 200 basis point improvement in DIY customer satisfaction scores and a 300 basis point improvement for the Pro. This represents the ongoing benefit of our

foundational technology investments, designed to modernize our stores operational process and simplify our associates' jobs while also creating a great shopping environment for our customers.

Let me highlight just a few of these changes. For starters, we created an industry-leading customer-centric scheduling system, which allows us to predict customer demand and align staffing around peak customer traffic for each store and each department. This system creates enhanced operational agility so we can rapidly adjust as demand patterns shift. Second, we've enabled greater productivity by putting mobile smart devices in all of our associates' hands to make them more efficient, reducing manual tasking and enabling faster customer service. For example, by integrating smart devices with our new store inventory management system, or SIMS, our associates can find products 40% faster.

And through Project Simple, we've eliminated duplicative tasks and reduced nonproductive hours, so we can re-purpose associate time from tasking to selling and service. A third foundational improvement is the expansion of our merchandising services team or MST. This team keeps our shelves stocked, and they recently assumed responsibilities for price changes across the store and watering in the garden center. MST is now leveraging a new app that directs them to serve a specific base based on the rate of sales, making their hard work even more productive and freeing up more time for our Red Vest associates to spend with customers.

Another important aspect of delivering excellent customer experience is convenience. That's why we're making a number of enhancements to create a more convenient shopping experience ahead of the holiday season.

For example, we're extending our same-day delivery to in-store purchases through our gig network to both Pro and DIY customers. And in certain locations, we'll even be delivering live Christmas trees to our customers' doors saving them the hassle of getting it home themselves. This new gig delivery capability, which we first rolled out on [lowes.com](#), enables us to tap into the One Rail network of 12 million drivers to deliver directly to Pro job sites and customer homes in just a matter of hours.

Our store operations team is also focused on unlocking even more productivity through our perpetual productivity improvement initiatives or PPI. This past quarter, we fully retired the old self-checkout systems and have shifted to the proprietary self-checkout systems that we've built for the home improvement shopper. We've seen greater customer adoption of these new systems since they're so much easier to use. In fact, our front-end transformation is well underway, with approximately 450 stores planned by the end of this year. Over a 3-year time line, we're revamping the checkout experience across all of our stores and increasing the selling space at the front where we're adding more merchandise right at checkout with a new design that makes it easy to showcase grab-and-go items. And with this front-end transformation, we're shifting to an easy-to-use assisted self-checkout with cashiers who will be right there to answer questions and help customers when they need it.

Finally, we're tripling the staging area for buy online, pick up in store orders to support increased online sales and create a much faster, easier customer experience building on our momentum when it comes to driving improved customer service scores for these orders. At the same time, we're excited to launch omni selling in our stores, a critical milestone in our journey to become a world-class omnichannel retailer, enabled by our new store operating system, we can now easily sell our endless aisle on [Lowes.com](#) within the aisles of our stores. For example, let's say, a customer is shopping for new faucets and browsing our selection of the most popular finishes in the store.

While talking with an associate, they decide to go with the unique finish from [Lowes.com](#) that the associate highlights on their mobile device. The associate then saves the faucet in the customer's digital cart with their phone number and the customer can continue shopping in the store. When the customer is ready to check out, all the cashier needs to do to combine the digital and physical purchases is pull up the digital cart using the customer's phone number. We're still in the early innings here, but we know this is a great opportunity to drive our omni sales and make sure our customers get everything they need to complete their project in one shopping trip.

As I close, I would like to thank all of our store leaders and associates once again for their hard work serving customers and delivering results each and every day. Thank you. And now I'll turn it over to Brandon.

Brandon J. Sink - Lowe's Companies, Inc. - Executive VP & CFO

Thank you, Joe, and good morning, everyone. Starting with our Q3 results. We generated diluted earnings per share of \$3.06. Please note, in the prior year, we recorded an asset impairment charge of \$2.1 billion associated with our Canadian retail business. Now my comments from this point will reference comparisons to certain non-GAAP measures from last year where applicable. Q3 sales were \$20.5 billion. For reference, prior year sales included \$1.2 billion generated in our Canadian retail business.

Additionally, Q3 results include a \$115 million sales headwind due to the shift in our fiscal calendar as we cycle over a 53-week year. Comp sales were down 7.4% as a slowdown in DIY bigger ticket spending offset growth in Pro. Q3 comps were negatively impacted by approximately 50 basis points due to lumber deflation. As a reminder, the calendar shift impacted total sales growth, but had no impact on comparable sales as comps are calculated based on weeks 28 through 40 in fiscal 2022. Comparable average ticket was down 0.5%, driven by lumber deflation, more normalized appliance promotions and a decline in big-ticket DIY transactions.

However, average ticket still increased in the majority of our merchandise categories. Comp transactions declined 6.9%, driven by softer demand in DIY discretionary projects partly offset by positive comp transactions in Pro. Our monthly comps were down 6.3% in August, 8.3% in September and 7.3% in October as DIY traffic slowed as we exited our peak seasonal weeks. Gross margin was 33.7% of sales in the third quarter, up 36 basis points from last year. Gross margin benefited from our ongoing merchandising PPI initiatives as well as favorable product mix and lower transportation costs. This was partially offset by costs associated with the expansion of our supply chain network and consistent with our year-to-date performance, shrink was in line with prior year.

SG&A of 18.4% levered 30 basis points versus prior year adjusted SG&A demonstrating our enterprise-wide agility to manage expenses and drive productivity in a lower sales environment. These results would not have been possible without the exceptional efforts of our store leadership teams to rapidly respond to the sales pressure as well as the ongoing benefits that we are harvesting from our technology-led PPI initiatives. Operating margin rate of 13.2% improved by 46 basis points versus prior year adjusted operating margin. The effective tax rate was 24.6%, in line with prior year adjusted effective tax rate.

Inventory ended the quarter at \$17.5 billion, down \$2.3 billion compared to Q3 of last year. U.S. inventory dollars and units were both down compared to last year as we align inventory purchases with sales.

Turning now to our capital allocation. During the quarter, we generated \$485 million in free cash flow. We repurchased 7.3 million shares for \$1.6 billion and paid \$642 million in dividends at \$1.10 per share, returning \$2.2 billion to our shareholders. Capital expenditures totaled \$579 million as we continue to invest in our strategic priorities within our Total Home strategy. Adjusted debt to EBITDAR finished the quarter at 2.72x in line with our stated 2.75x leverage target.

Finally, we delivered return on invested capital of 35%, inclusive of an unfavorable 125 basis point impact related to transaction costs associated with the sale of our Canadian retail business and the gain we reported in Q1.

Now turning to our 2023 financial outlook. Given the recent pullback in DIY, bigger ticket discretionary spending and the uncertainty surrounding the macro factors that impact our business, we are updating our full year 2023 financial outlook. With this in mind, we are now forecasting Q4 comp sales to be fairly consistent with Q3 results. Also, the fourth quarter of 2022 included approximately \$1.4 billion in sales from the additional 53rd week. We are now expecting 2023 sales of approximately \$86 billion with a comparable sales decline of approximately 5%. We also now expect adjusted operating margin of approximately 13.3% as our ongoing PPI initiatives and disciplined expense management helped to offset volume deleverage pressure from lower sales.

Additionally, we expect full year interest expense of approximately \$1.4 billion, capital expenditures of up to \$2 billion and an adjusted effective income tax rate of approximately 25%. This results in an updated outlook for adjusted diluted earnings per share of approximately \$13.

Please note that our outlook for operating margin and diluted earnings per share are adjusted to exclude the gain associated with the sale of our Canadian business that we recorded in Q1.

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Finally, we are reconfirming our capital allocation priorities. We will continue to invest in the business to take market share, target a 35% dividend payout ratio and then return excess cash to shareholders through share repurchase, which will be funded in the near term through free cash flow.

And in closing, I'm confident that our continued investments in our Total Home strategy, our strong balance sheet and our ability to effectively manage our business in any environment will allow us navigate the near-term challenges while continuing to deliver sustainable shareholder.

And with that, we will open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Steven Forbes with Guggenheim Securities.

Steven Paul Forbes - *Guggenheim Securities, LLC, Research Division - Analyst*

Marvin, you mentioned in your prepared remarks the 300 rural stores comping above average and some of those categories being the best performing ones. So curious, if you can maybe help reframe how you guys are thinking through the more medium-term and longer-term opportunity there. How many stores do you think can accommodate such an assortment? And any contextualization of the spread in the DIY comp in the 300 stores versus the company average?

Marvin R. Ellison - *Lowe's Companies, Inc. - President, CEO & Chairman*

Steven, thanks for the question. We're not going to get into that level of specificity for competitive reasons, but what I will tell you is that the rural stores have exceeded expectations. And as we noted, we started out with roughly 300. But candidly, the performance and the customer response has been such that we're now looking at a couple of different options. One option is we're going into those original 300, and we're adding incremental investments initiatives, categories based on feedback from customers. We're also looking at categories that are working really well in those rural stores and asking the question, can we now take some of these categories and put them in nonrural format locations because we believe we could get the same response from customers in nonrural environments.

And then thirdly, we're just looking at expanding our profile and definition of rural because some of these characteristics, we think can fit other locations. And because of the response and because of the DIY customer being such a critical component of our company strategy, we think this makes a really good strategic rationale and it's something that we're pursuing. But again, we'll speak more about this on future calls, but I don't want to get into more specifics for obvious competitive reasons.

Steven Paul Forbes - *Guggenheim Securities, LLC, Research Division - Analyst*

And then maybe sticking with some initiatives here and maybe a follow-up for Bill. The front-end transformation, we're probably far enough right into it where it'd be helpful if you maybe frame the ROI of such transformations. I don't know if you can sort of maybe go through what you're seeing in terms of comp lift and/or just what is the outlook right for next year as we think through the maturation benefit of such an agenda.

William P. Boltz - *Lowe's Companies, Inc. - EVP of Merchandising*

Yes. So as Joe said, we've got roughly 450 stores that we'll complete by the end of the year. We continue to test and learn in these stores. As you can imagine, there's opportunities for us to try some additional merchandising opportunities up front of the store. It's all about getting another item in the basket, and there's opportunities in the obvious areas like snacks and drinks, but we're also looking at other categories as well that can

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complement what we're doing and also that shopper, both a Pro and a do-it-yourselfer that's making that transaction in our store that could pick that kind of stuff up and you think about like aspirin, band-aid, stuff like that, that could complement what they're doing and could be used on a job site or in a glove box of a car or at your home.

Marvin R. Ellison - *Lowe's Companies, Inc. - President, CEO & Chairman*

And Steve, the other thing that I'll add is this also complements the ongoing omni expansion that Joe talked about. As we extend these capabilities of connecting digital and physical stores, we need more productive space, and we need to just optimize all the things that the associates are doing to accommodate and fulfill those orders. And as Joe mentioned, part of this is to create more designated space in a more productive fashion for that process, but also it's creating a much better customer experience, and it's also driving a lot of productivity for Joe's team in the store.

Operator

Our next question is from the line of Peter Benedict with Baird.

Peter Sloan Benedict - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Just kind of curious as you talked a lot about the PPI initiatives and your ability to try and be agile with expenses. If we think kind of longer term, think maybe out to next year, if there's another environment where comp store sales are maybe down in the mid-single-digit range. How do we think about your ability to manage margins in that environment? I know some of the benefit this year is cycling Canada, but just maybe some benchmarks to think about as we move to next year on how the P&L could act in different top line environments.

Brandon J. Sink - *Lowe's Companies, Inc. - Executive VP & CFO*

Yes. Peter, this is Brandon. Just in terms of as we're looking at 2024, we're in the later stages of our planning process at the moment across the organization. So we're going to hold off on providing any in-depth guidance until our Q4 call. But what I will tell you just in terms of top line macro home improvement, there's continued uncertainty on interest rates, when we're going to see relief when existing home sales are going to turn the corner and begin to improve. And obviously, the ongoing impact of inflation, higher rates on consumer wallet. So we're watching all that. I think to your specific question on margins, we're managing several puts and takes as we look at next year. We're cycling onetime legal settlements, normalization of incentive comp, wage growth, the pacing of our PPI initiative. So we're looking at all that. We're going to take all those factors under consideration as we develop our guide and hold off on providing that until we get to February.

Marvin R. Ellison - *Lowe's Companies, Inc. - President, CEO & Chairman*

Peter, this is Marvin. And the only thing I'll add is you heard in some of the prepared comments, was talking about an old operating system. And we talked a lot about this 30-year-old operating system. There's really been a significant impediment to some of the technology advancements, and we're going to be sunsetting that system at the end of this year, and it's going to just unlock a little bit of acceleration in some of the technology advancements that we have on the project list. We just candidly, we couldn't get to because of this system. And so the good news is we're going to continue to work to Brandon's point on all the elements of running an improved business from a merchandising store operations, supply chain, but also the technology project list over the next 3 to 5 years is robust, and it's going to allow us to continue to find ways to drive profitability, irrespective of the macro environment that we're in. We're hoping the macro environment gets better with Brandon's point. We're going to wait until our Q4 call to talk about '24 and give a much more educated perspective at that time.

Peter Sloan Benedict - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

All right. Fair enough. Appreciate that perspective. I guess my follow-up would be just around maybe the cost environment that you're seeing out there, a lot of talk of -- obviously, disinflation and some outright deflation in certain areas. What are you seeing right now in terms of the cost you're receiving from your suppliers? And how do you kind of view that as we look out over the next few quarters.

Brandon J. Sink - *Lowe's Companies, Inc. - Executive VP & CFO*

Yes, Peter, this is Brandon. I would say just in terms of costs coming into the organization at this point, just from an inflation price action response to that. It's leveled off pretty dramatically here as we move through the year. We've had targets in terms of clawback for this year. We laid those expectations out back in December, I would say, very much pacing in line with those targets. We laid out about \$500 million over the course of 3 years. We're leveraging cost management teams, working closely with the merchants, the tech-enabled tools that we've invested in. We have very detailed product cost breakdowns that are informing those negotiations with our suppliers. So we're continuing to be balanced. We're taking a portfolio approach. We're investing in price strategically where needed, but also looking through the lens of protecting our margins.

Operator

Our next question is from the line of Simeon Gutman with Morgan Stanley.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

I want to try to take another stab at this margin question for next year. I know there's not a whole lot you can provide. If you think about the levers that you have do you lose any for next year? I realize you're going to lap the legal settlement in the first part of the year. And then connected to it, as you manage your selling expenses, do you think that's having an impact on sales at all? Meaning, is that not something you press on is hard for next year?

Brandon J. Sink - *Lowe's Companies, Inc. - Executive VP & CFO*

Yes. Simeon, this is Brandon. I wouldn't say when we look at next year, we're losing the benefit of any of those levers. In fact, I think we're looking at where we have opportunities to accelerate. We've talked about PPI, I talked about where we were in that journey in terms of middle innings. Marvin mentioned the conversion of the store technology to a modern omnichannel platform. We got a lot of initiatives stacked up where we expect to see those benefits as that gets delivered next year. Earlier question on transforming the front end really expanding assisted checkout, expanding the BOPIS experience, and then Bill talked in his prepared comments about multiple other kind of merchandising PPI initiatives, whether it's cost clawback, inventory productivity, pricing, promotional strategies, expansion of private brands. So we're really confident in that portfolio of initiatives. We feel like it's in our control. We're managing the road map and the pacing of that and have a lot of confidence as we look at the longer-term margins that we can deliver against our stated targets there.

Marvin R. Ellison - *Lowe's Companies, Inc. - President, CEO & Chairman*

So Simeon, this is Marvin. I'll add this perspective. The reason why we call this a perpetual productivity improvement initiatives because we're trying to stay away from onetime events. We think that good companies create an ongoing sustained process of improvement and productivity gains. And so we have a road map of initiatives. And it's important that it's not just about store operations. You heard Bill talk about the PPI initiative, specifically for merchandising. If Don Friesen was here, he could speak specifically to supply chain and Seemantini could speak specifically for IT.

And so this is a culture that we've created here that candidly did not exist, but the key word is perpetual. And that means that it's ongoing, it's consistent and it's sustainable. And so as we look at '24, we know we're not going to get into the details. What Brandon is reinforcing is that we have a list of things that we're going to do. We're well aware of what we're overlapping. We understand some of the onetime factors we're going

to face. And we built processes, initiatives in place to address that. And we'll be more transparent and more detail in our Q4 call because we think it's really important to lay out to you all exactly how we see it and the steps we're going to take.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

So my gentle follow-up to that, Marvin, is you have OpEx productivity and PPI. Those are the two biggest unlocks. I -- Just to clarify or an assumption, it doesn't sound like what the business comps has anything to do on what those two buckets produce. And then is there a situation in which those two buckets actually produce more in terms of sequencing in '24 than what it was yielding in '23.

Marvin R. Ellison - *Lowe's Companies, Inc. - President, CEO & Chairman*

So I'll give you the perspective of a long-term operator. If we get the top line, PPI works a whole lot better. So irrespective we're going to intensify the focus. Obviously, if we have a softer top line perspective, we're going to be a lot more aggressive in the PPI side. But irrespective of our comp outlook, PPI is going to be in existence, and we're going to work really hard to make sure that we hit some of the key targets that we lay out. And again, you have our commitment that as we lay out 2024 as best we can, we'll be as transparent as possible about all of these things in our February call.

Operator

Our next questions are from the line of Chris Horvers with JPMorgan.

Christopher Michael Horvers - *JPMorgan Chase & Co, Research Division - Senior Analyst*

I want to focus a bit on the top line. You've seen increased big-ticket sensitivity, others are talking about, you mentioned flooring. People are doing smaller projects, you're not buying the suite of appliances, you're doing the bathroom, not the entire first floor and flooring. I guess -- so my question is, why isn't the Pro and the remodel business or maybe the remodel business and the answer is different from you on the Pro because of share, but why isn't the remodel business and the Pro business the next shoe to drop? And given the changes that you've seen over the past 3 or 4 months, how are you thinking about the bottom of the comp cycle and sort of when does it start to revert back to positive?

Marvin R. Ellison - *Lowe's Companies, Inc. - President, CEO & Chairman*

So Chris, I'll take the first part of that, and I'm going to just let Bill Boltz talk about some of the initiatives relative to addressing some of the top line concerns. So specific on sales for us, when we look at the quarter, we look at it from a penetration from a DIY perspective and a product mix. So as a reminder, 14% of our revenue comes from appliances. So when you have pull back on some of these big-ticket categories like appliances, is going to be disproportionately impactful for us.

Having said that, we look at the Pro and to your point, we had a positive comp, and we're really pleased with that, and I went through some of the investments we've made over the course of the last 4 years that we believe are paying dividends relative to that specific small or medium Pro. And the reason we think that, that specific segment of Pro will remain healthy, although cautious, as we've noted from our survey is because of the age of homes. I mean it is a foregone conclusion that if you have a house over 40 years old, things are going to break. And when those things break and those repairs are required that smaller-to-medium contractor is typically the one that's going to get that call.

And these pros are incredibly transparent with us and 70% say they feel really good about their backlog. But they also said that when they watch the news and they read the headlines, they're a little cautious because they just don't know what's lurking around the corner, but they're busy because these homes are old. These homes are not turning, so people are living in these homes. And so that's really the driver of that customer segment remaining healthy and busy. And look, we can't predict the bottom. But what we can say is that we're incredibly disciplined. Anytime you can deliver a 46 basis point improvement in operating margin on a negative 7.4% comp.

It tells you that there are a lot of really things working from a productivity standpoint that drives margin rate improvement and basis point improvement in customer service that we're really proud of. So we feel good about the execution of the team, and we can't predict kind of what's going to happen when, but we can say whenever it happens, we're well positioned to take advantage of it. And I'll pivot to Bill just to talk about kind of what we're trying to do to remain agile and to try to make sure that we are driving a business environment that's attracting DIY customers and keeping these Pros coming back also.

William P. Boltz - Lowe's Companies, Inc. - EVP of Merchandising

Yes. Thanks, Marvin. And Chris, just some of the things that we've talked about really over the last few quarters that I'm pleased with the work that the team has done is the continued acquiring of brands and making sure that we've got relevant assortments inside of our stores and online. And so we announced today Toro as part of our outdoor power equipment. We talked about Klein last quarter, and we're just starting to get that brand now into the electrical and the tool category. So that's excitement for us. We talked about localized assortments and Marvin touched briefly on the rural strategy. That's just one element of a localized opportunity.

And then we continue to try to pivot to where the customer is. So as -- we've seen some of the softening in appliances from an industry-wide standpoint, because we're the industry leader here, we want to make sure that we can meet the customer where they want us to meet them, and that's adjusting. And so we feel like the adjustments the teams have made to make sure that we can go after the 100,000-plus appliances that break in the United States every single week that we're there when the consumer needs us both online and in-store. We continue to enhance our fundamentals and our foundation online. And so offering Apple Pay as a way to make it easier for the customer to transact online. This is just one element, same-day delivery and then obviously being seasonally relevant.

As we go into this Friday with Black Friday, it's about making sure that we've got strong offers out there that gets the customer to the door into the website. And that's the stuff that we'll continue to do. And at the same time, we have to be competitively priced. We've got to be relevant every single day. And so that's the kind of work that the team continues to stay focused on. And it takes time, obviously, to get that customer to know that these changes have happened inside of our store and online, and we're just going to just stay focused on what we can control.

Christopher Michael Horvers - JPMorgan Chase & Co, Research Division - Senior Analyst

And then my follow-up is, again, on the Pro side. As you think about the momentum in that business over this year or what you're seeing in the basket in terms of the projects that they're doing. Whether it's size or price point -- price spectrum, is there any change in momentum on the Pro side of the business?

Joseph Michael McFarland - Lowe's Companies, Inc. - EVP of Stores

Chris, thanks for the question. And listen, we can tell you that with the Pro loyalty and CRM that we launched, we continue to view the basket. We continue to view the mix. We are very encouraged and continue to exceed expectation in the core metrics. And we continue to launch new capabilities, things like online quotes for the bulk pricing that Bill talked about. In my prepared remarks, I mentioned the integrated same-day gig delivery, streamlined order tracking. And so there's a lot going into that Pro from an effort standpoint. And so we continue to be pleased at the progress.

Operator

Next question is from the line of Seth Sigman with Barclays.

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Seth Ian Sigman - Barclays Bank PLC, Research Division - Research Analyst

So I wanted to follow up on pricing and promotional activity. Obviously, you talked about elevated promotions in appliances, and how that's being funded by vendors. I realize that category is a little bit unique, but how would you categorize discounting activity across other categories? And maybe you could also just elaborate on what you have seen and what you've been doing with that low price guarantee?

William P. Boltz - Lowe's Companies, Inc. - EVP of Merchandising

Yes, Seth, it's Bill. And so just a couple of things here. As I said, we are seeing probably more of a move on pre-pandemic levels of promotion, specifically in the appliance area. These are largely vendor supported, but we want to make sure that we're there, obviously, and we're part of all that. As it relates to the overall, the industry remains pretty rational and pretty stable. You want to make sure that at certain times of the year, you're out there with the relevant offers and that you're doing the things that you need to do. So whether that's in the spring or this Black Friday, we're excited about having some of those offers out there and working within the guardrails and the profitability targets that we've established.

But all in all, it remains, I think, relatively rational. I think the consumer is looking for value, and so we've got to find different ways to highlight value, and those are the things that this team is doing and value can come a lot of ways outside of just a reduction in price. You can highlight it through new and innovative products. You can highlight it through a special offer if that's what comes out, or we can do it through a vendor-funded promotion. So those are things that we're trying to take advantage of.

Brandon J. Sink - Lowe's Companies, Inc. - Executive VP & CFO

And Seth, this is Brandon. I would just add the adjustments that Bill is talking about that we're making as the consumers changing as we're moving through the year, our go-to-market strategy, all of that's fully embedded and reflected in our updated outlook and confidence that we're able to achieve our flat gross margins for the year.

Marvin R. Ellison - Lowe's Companies, Inc. - President, CEO & Chairman

And Seth on a low price guarantee, our research just indicated that we needed a more simplistic straightforward message to the customers about our value. We had something that was a little too cute, call it, a price promise that I think was way too ambiguous, and we just decided just to keep it simple and stand by the fact that we will support the lowest price in the industry on the products that we sell. We just launched it. We think the timing is perfect going into a holiday season where you have a slightly cautious consumer looking for a value. And so you take everything that Bill said about the definition of value and the fact that we're going to put media behind this lowest price guarantee. We hope that sends a message to the consumer that they could always expect a lowest price at Lowe's.

Seth Ian Sigman - Barclays Bank PLC, Research Division - Research Analyst

Okay. That's very helpful. I did have one follow-up on capital allocation, specifically share repurchases. Just based on what you've done year-to-date, where leverage sits today, how do you think about the pace of buybacks from here? Should we be thinking about that starting to slow into the fourth quarter and even over the next couple of quarters based on the demand backdrop. How do we think about that?

Brandon J. Sink - Lowe's Companies, Inc. - Executive VP & CFO

Seth, this is Brandon. So our capital allocation priorities unchanged. We're going to continue to invest in the business in high-return projects, targeting a 35% dividend payout ratio and funneling the remainder to share repurchases. As I mentioned in my prepared remarks, we do expect funding share repurchases through operating cash flow here in the near term and expect modest if any share repo in Q4 also expect to be in line with our stated leverage target at the end of the year. So we're also looking at our debt towers, paying those off as they mature. We have \$500

million this past Q3. We have \$450 million coming due in 2024, and we remain committed to our BBB+ credit rating and expect to manage our leverage accordingly.

Operator

Next question is from the line of Michael Lasser with UBS.

Michael Lasser - UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines

Given the importance of sales to the PPI initiative, if you're looking at, call it, another down 5% comp next year, do you start to become more aggressive with promotions or other actions in order to start to drive sales because you'll get a return on it in other ways?

Marvin R. Ellison - Lowe's Companies, Inc. - President, CEO & Chairman

Michael, we're not going to get into 2024 at this time. We'll speak more specifically about that on the Q4 call. What I'll just repeat is PPI is perpetual for a reason. We're going to keep doing it. It's sustainable, it's ongoing, and we're going to be agile. We'll take the necessary steps to make sure we're running a really sound business thinking first about driving service for the customers and giving our associates a great place to work. But other than that, PPI will be in place irrespective of top line, and we'll adjust it accordingly.

Michael Lasser - UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines

Okay. My follow-up question is, Marvin, as you look at your sales by market, by region, and tie to the underlying housing characteristics and dynamics in those markets, where are you seeing better trends? And where are you seeing worse trends such that it informs how you think about how the rest of this cycle is going to unfold from here. It's likely at some point, hopefully, housing turnover is going to pick up. That could bode well for home improvement demand. But if it comes with a corresponding tick down in home prices, that could be not so good for home improvement demand.

Marvin R. Ellison - Lowe's Companies, Inc. - President, CEO & Chairman

Michael, it's a fair question. If you strip out storm overlaps, geographically, our performance is relatively balanced. So there are really no outliers. When you look at markets that had a dramatic run-up in housing costs and some level of moderation, there's really no material impact to our business based on that. Obviously, it's something that we stay very close to. We're paying attention to it. But as of right now, it's not material, and we don't see it as something that's going to affect our business in the near term.

Operator

Next question comes from the line of Brian Nagel with Oppenheimer & Company.

Brian William Nagel - Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst

So a couple of questions on top line. I'm just going to merge them together. But first off, a big follow-up just on appliances. So Marvin, you talked about maybe some normalization in overall promotion vendor led. I guess the question I have on appliances, are you seeing anything shift in the market? I mean obviously, we're against the demand backdrop. But are you seeing anything shift from a competitive standpoint? And then my second question, just with respect to the underlying cadence of the business. We saw, it would appear to be a weakening trends through the fiscal third quarter and then presumably here into the fourth quarter. Anything that you can -- clearly, there's seasonal factors there, but is there anything else you could really call out that they have -- you guys identified as kind of a driver of that we can trend the overall business?

Marvin R. Ellison - *Lowe's Companies, Inc. - President, CEO & Chairman*

Michael, I'll take both and just allow Brandon or Bill to jump in if they have any additional comments. On the appliance shift, I mean we're not seeing anything other than what Bill talked about, where you have vendor-funded promotions kind of driving average ticket down. And also, as we mentioned in the prepared comments, we're seeing customers being just a little more specific on their purchases going from an entire suite to just a refrigerator as an example.

And I think this is just the cautious nature of the DIY discretionary spending on some of these bigger ticket categories we talked about. We already market leader in the U.S. in appliances. And as I mentioned earlier, 14% of our annual revenue is predicated to appliances. And so when the market is soft, we have a disproportionate impact. Having said that, we feel great about our market-leading position. And as Bill outlined, we have some competitive offers on single unit purchases for the holiday season, that's the best in the industry. And so we feel like we're in a good place relative to the marketplace.

On weakening trends, there's not anything we can put our finger on it. I mean you know all the macro indicators with the resumption of student loan debt and sustained inflation, interest rates. And I just think that those things combined with the fact that people are just choosing to take discretionary dollars and have more experiences with those dollars is really leading into some of the things that we're seeing. And when those discretionary categories are impacted, those are typically DIY-related purchases. And again, at 75% penetration in DIY, we just have a disproportionate impact to that. So I'll let Brandon or Bill add anything else if they have it in addition to what I just said.

William P. Boltz - *Lowe's Companies, Inc. - EVP of Merchandising*

The only thing that I would add, Brian, is that just, as I said earlier, just a reminder that over 100,000 units of appliances break in the marketplace every week. And we've got to be there for that consumer as the market leader, and that's what we're trying to do and do that in a responsible manner to make sure that we can hit all the financial targets that we need to hit. But also make sure that we can meet the customer where they want to be met, both online and in-store.

Brandon J. Sink - *Lowe's Companies, Inc. - Executive VP & CFO*

Yes. And Brian, this is Brandon. Just to wrap it out in terms of how we are looking at Q4. I think our outlook largely a continuation of the macro and the traffic trends that we've experienced in Q3. We do expect a light or a slight impact from lumber deflation as we transition into Q4. All of the offers that Bill has talked about with appliance holiday offers are reflected in there. We do expect some light pressure from cycling Hurricane Ian. So we've triangulated all that. We've looked at 1, 2, 4-year trends all of that sort of baked into the expectations that we set, and we believe it's very achievable for us here for Q4.

Kate Pearlman - *Lowe's Companies, Inc. - VP of IR*

Thank you all for joining us today. We'd like to wish everyone a Happy Thanksgiving and a wonderful holiday season, and we look forward to speaking with you on our fourth quarter earnings call in February.

Operator

Thank you. This concludes the Lowe's third quarter 2023 earnings call. You may now disconnect.

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