HD – Q4 2016 Home Depot Earnings Call
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PRESENTATION

Operator

Good day and welcome to The Home Depot Q4 2016 and 2016 fiscal earnings conference call. Today's call is being recorded.

(Operator Instructions)

At this time, I'd like to turn the conference over to Ms. Diane Dayhoff, Vice President, Investor Relations. Please go ahead.

Diane Dayhoff - The Home Depot, Inc. - VP, IR

Thank you, Catherine and good morning to everyone. Joining us on our call today are Craig Menear, Chairman, CEO and President; Ted Decker, EVP of Merchandising; and Carol Tomé, Chief Financial Officer and Executive Vice President, Corporate Services.

Following our prepared remarks, the call will be open for analyst questions. Questions will be limited to analysts and investors, and as a reminder we would appreciate it if the participants would limit themselves to one question with one follow-up please. If we are unable to get to your question during the call, please call our investor relations department at 770-384-2387.

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

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

Now let me turn the call over to Craig.

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

Thank you, Diane, and good morning everyone. Fiscal 2016 was a record year for our business as we achieved the highest sales and net earnings in company history.

Fiscal 2016 sales group $6.1 billion to $94.6 billion, an increase of 6.9% from fiscal 2015, while diluted earnings per share grew 18.1% to $6.45. Sales for the fourth quarter were $22.2 billion, up 5.8% from last year. Comp sales were up 5.8% from last year and our US stores had positive comps of 6.3%. Diluted earnings per share were $1.44 in the fourth quarter.
We continue to see broad-based growth across the store and our geographies. All three of our US divisions posted positive comps in the fourth quarter as did all 19 US regions and top 40 markets.

Internationally, both our Mexican and Canadian businesses posted positive comps in local currency for the quarter, making it 53 and 21 quarters in a row of positive comps, respectively. Our merchants and store teams did an outstanding job delivering value and service for our customers across multiple events throughout the quarter both in stores and online. As

Ted will detail, both ticket and transactions grew in the quarter and all of our merchandising departments posted positive comps.

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

The rollout of Interline's catalog of products is now taking place across all US Home Depot stores. The next phase of the integration is focused on enabling Interline's customers to use their Interline accounts for purchases in Home Depot stores or on HomeDepot.com. We are excited about the opportunity Interline provides us to expand our share of wallet with pro customers.

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

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

As you know, our interconnected business is much more than our online properties as it seeks to blend the physical and digital worlds are seamlessly to enable customers to shop with us whenever and however they choose. A key component of the strategy has been the investments that we've made to meet customers' demands for increased fulfillment options. This quarter we completed the rollout of BODFS or Buy Online Deliver From Store. BODFS was built on a foundation of our new customer order management system, or COM, which was a fully deployed in all US stores during the second quarter of 2016. We are pleased with a positive customer response to this enhanced delivery option which streamlines the delivery experience for both our customers and our store associates.

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

Turning to 2017, overall GDP growth and the strength in the US housing market should continue to support growth in our business. As Carol will detail, we expect 2017 comp sales of approximately 4.6% and diluted earnings per share of $7.13.
It was announced today that our board approved an increase in our targeted dividend payout ratio from 50% to 55% and a 29% increase in our quarterly dividend, to $0.89 per share, which equates to $3.56 annually. The board also authorized a new share repurchase program of $15 billion.

We remain committed to a disciplined capital allocation strategy to create value for our shareholders. We will invest to sustain and grow our business and return value to our shareholders through dividends and share repurchases.

Over the past two years, we grew our sales by over $11 billion. This was accomplished during a time when we introduced a great deal of change into the business, not just in the US but in Canada and Mexico, as well.

Projects like COM and BODFS, the acquisition of Interline and our supply chain initiatives challenged our associates to adapt and learn to do old things in new ways. Our orange-blooded associates repeatedly rise to meet these new challenges head on. Demonstrating the entrepreneurial spirit and passion for our customers that has made The Home Depot what it is today. I want to close by thanking these associates for their hard work and dedication to our customers in the fourth quarter and throughout the year.

For the second half of the year 98% of our stores qualified for Success Sharing, our profit-sharing program for our hourly associates. We look forward to continuing this momentum in 2017.

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

Ted Decker - *The Home Depot, Inc. - EVP, Merchandising*

Thanks, Craig, and good morning everyone. We had a strong fourth quarter as sales exceeded our expectations. We saw strength across the store led by our pro customer and our online business continued its double-digit growth with sales growth of approximately 19% in the fourth quarter.

All of our merchandising departments posted positive comps, led by flooring and tools which had double-digit comps in the quarter. Lumber, outdoor garden, appliances, decor, indoor garden, lighting and plumbing were above the company's average comp. Hardware, millwork, electrical, kitchen and bath, building materials and paint were all positive but below the company average.

We continue to see balanced growth between transactions and average ticket in the quarter. Total camp transactions increased 2.8% while comp average ticket grew by 2.9%. Our average ticket increase was slightly impacted by commodity price inflation and foreign currency. Commodity price inflation positively impacted ticket growth by approximately 32 basis points, while a weaker Mexican peso negatively impacted ticket growth by approximately 45 basis points. Looking at big-ticket sales in the fourth quarter, transactions over $900, which represent approximately 20% of our US sales, were up 11.6%. The drivers behind the increase in big-ticket purchases were flooring, appliances and several pro categories.

Once again pro sales grew faster than the company comp. We saw strong comps in pro heavy categories like fencing, pressure-treated decking, commercial and industrial lighting, electrical wiring, and interior doors. We also saw strength with our DIY customer. Classes that outperformed included special order carpet, outdoor power, laminate flooring and storage. We drove record sales in each of our Black Friday, gift center and holiday programs. Our customers responded to our great values as traffic increased inside our stores and online. And we recorded our highest Cyber Week ever. Our events helped drive robust comps in decorative holiday, tool storage, power tools and appliances.

As part of our focus on balancing the art and science of retail, we continue to refine and localize our assortments. In our outdoor garden category, we are leveraging the power and agility of our local garden merchants. These merchants work directly with our stores and local growers to ensure we have the right mix of products to meet the demands of each individual community.

As an example, during the drought in the West our merchants sourced the highest-quality drought-resistant live goods. As we look forward to this spring our local merchants are adjusting the assortment to meet current demand given much wetter conditions. As customer preference continues to evolve and change we will have local customized assortments so the right product is always available.

Now let's turn our attention to the first quarter. We are committed to being the product authority for home improvement. Product authority means having the best brands at great everyday values for our customers.

With this we are excited to introduce Milwaukee's new lineup of a cordless outdoor power equipment. This lineup will include a string trimmer, blower and hedge trimmer that are all part of the M18 platform of 125-plus tools. These professional grade products have 18-volt power, a brushless motor and come with a 9-amp power battery that delivers unmatched power and runtime. These Milwaukee products are a big-box exclusive.

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

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

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

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

Thank you Ted, and good morning everyone. In the fourth quarter sales were $22.2 billion, a 5.8% increase versus last year. Foreign currency rates, primarily a weaker Mexican peso, negatively impacted total sales growth by approximately $96 million or 0.5%.

Our total company comps or our same-store sales were positive 5.8% for the quarter but positive comps of 5.7% in November, 7.1% in December and 4.7% in January. Comps for US stores were positive 6.3% for the quarter with positive comps of 6% in November, 8% in December, and 5.1% in January. For fiscal 2016, our sales increased 6.9% to $94.6 billion and total company comp sales were positive 5.6%. Comps for US stores were positive 6.2%. During the year, a stronger US dollar negatively impacted sales growth by approximately $549 million, or 0.6%.

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

For the year, we experienced 3 basis points of gross margin contraction. In the fourth quarter operating expense as a percent of sales decreased by 113 basis points to 20.8%. Our expense leverage was driven principally by our strong sales performance and good expense control.

Our total Company expenses were $11 million higher than planned due to expenses associated with our 2014 payment data breach. With this we now believe the majority of expenses associated with our payment data breach are behind us.

Fiscal 2016 operating expense as a percent of sales was 20%, a decrease of 92 basis points from what we reported last year. For the year our expenses grew at 30% of our sales growth rate. Our operating margin for the quarter was 13.2% and for the year was 14.2%.

Reflecting favorable tax reserve adjustments in the fourth quarter our effective tax rate was 35.2% and for the year our effective tax rate was 36.3%. Our diluted earnings per share for the fourth quarter were $1.44, an increase of 23.1% from last year. For the year diluted earnings per share were $6.45, an increase of 18.1% compared to fiscal 2015.

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

Moving onto capital allocation, in fiscal 2016 we generated approximately $9.8 billion of cash from operations and used that cash as well as proceeds from $2 billion of incremental long-term debt issuances to invest in the business, repurchase our shares and pay dividends to our shareholders. During the year we invested approximately $1.62 billion back into the business through capital expenditures. Further, we repurchased approximately $7 billion or about 53 million of our outstanding shares including roughly $2.4 billion or 18 million shares in the fourth quarter. And finally, during the year we paid $3.4 billion in dividends to our shareholders.

Computed on the average of beginning and ending long-term debt and equity for the trailing 12 months, return on invested capital was 31.4%, 330 basis points higher than at the end of fiscal 2015.

Now looking ahead, this morning we issued a press release with our guidance for fiscal 2017, and I want to take a few moments to comment on the highlights. Remember that we guide off of GAAP, so our fiscal 2017 guidance will launch from our reported results from fiscal 2016.

As we look to 2017 we remain encouraged by the strength of our core business and by what we are seeing in the housing environment. While private fixed residential investment as a percentage of GDP now stands at 3.8%, it has a way to go before it reaches the historical mean of 4.5%. Home price appreciation, housing turnover and household formation continue to be tailwinds for our business.

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

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

For fiscal 2017, we are projecting our gross margin rate to decline by approximately 15 basis points from 2016 as we are planning for outpaced growth and lower margin categories such as appliances and certain building material categories. On the expense front, we are forecasting our expenses to grow at approximately 49% of the rate of our sales growth, in line with the long-term guidance we provided to you in 2015.

For the year, we expect that our operating margin will grow by approximately 30 basis points to 14.5%, reaching our fiscal 2018 target one year in advance of our goal. We will update our fiscal 2018 operating margin target at our Investor Conference scheduled for later in the year.

For the year, we expect our effective tax rate to be approximately 36.3%. Starting with fiscal 2017, we are adopting FASB accounting standard update 2016-09 for employee share-based compensation. Note that the estimated positive impact of this new accounting standard is reflected in our projected tax rate, but the actual impact won't be fully understood until equity grants are exercised throughout the year.

We expect our fiscal 2017 diluted earnings per share to grow approximately 10.5% to $7.13. Now as Craig mentioned in his remarks, in support of our commitment to return value to shareholders our board just announced a new share repurchase authorization of $15 billion, replacing our existing authorization. Our earnings per share guidance includes our plan to repurchase approximately $5 billion of outstanding shares during the year using excess cash.

For the year we project cash flow from the business of roughly $11.3 billion. Our 2017 capital spending plan is approximately $2 billion. We will use this capital to support our strategic initiatives and invest in our aging store base to improve the customer experience.

In addition to capital spending and share repurchases, we will use our cash to pay $4.2 billion in dividends to our shareholders. As Craig mentioned, our board just announced an increase in our targeted dividend payout ratio from what was 50% to now 55%. With that we announced a 29% increase on a quarterly dividend which equates to an annual dividend of $3.56. Our disciplined approach to capital allocation continues to be evidenced by the investments we are making in our business and the cash returned to shareholders.

We thank you for your participation in today's call. And Catherine, we are now ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Simeon Gutman, Morgan Stanley.

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

Thanks, good morning and congratulations on the results. My first question is on, I guess, the balance between the same-store sales guidance and the gross margin guidance. How should we think about market share gains in that 4-6 versus the mix of product and/or, I don't know if it's promotion, but maybe just mix of product and maybe being more aggressive in the appliance area?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

I will start and I will let Carol comment. When you look at the projected margin, as we said we are intending to lean into growth in categories that are lower margin rate categories like appliances but also as our pro business continues to grow with categories in building materials. So that's really what we're looking at as it relates to the gross margin.

And if you think about the last two years, gross margin has roughly been about 3 basis points. With the 15 next year that's about a 12 basis point decline, and we consider that to be pretty flat.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

And maybe I will just add a little color about our sales forecasting model. As you know, it starts with GDP growth forecast and for the US GDP is projected to grow by 2.3% in 2017. We then add to that the benefits we believe we will get from rising home prices, housing turnover and household formation, and we think housing will add another 1.5 points growth to our overall growth next year.

To that we have added a little bit of share shift in appliances and certain building categories, and just to put that in perspective and 2016 appliances contributed 50 basis points of our comp growth. So that gives you a sense of the share that we are including in our guidance. And then we are adding something else this year that we haven't included in the past, and that's what we call the cumulative wealth effect upon price appreciation.

If you look at home equity, since 2011 home equity is up 108%. On average that equates to $50,000 per household. And we believe that is contributing, as people use the equity of their houses to spend back into their house we believe that's contributing to our growth, so we factor that into our guidance, and that's how we got to the 4.6%.

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

Got it. Okay, that's helpful.

My follow-up on SG&A, I think the guidance suggests that the dollars grow, I guess, 49% relative to sales and, of course, Home Depot has had a strong bias to do better than its expense guidance over the years. As we look out to next year, is there anything in the mix that would prohibit or prevent you from maybe upside, is there anything structural about the complexion of SG&A next year?

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

Let me walk you through how we got to our guidance for 2017. As we commented in 2016 our expenses grew at 30% of our sales growth rate. A bit of that was distorted because of payment data breach expenses that were incurred in 2015 and did not repeat in 2016.

So if you ignore the payment data breach our expenses in 2016 grew at about 38%, call it 40%, of our sales growth rate. Stepping up to 50% in 2017 for a few reasons. We, like many companies, are facing rising wages as well as higher medical costs and we have factored that into our guidance. It doesn't mean that we won't drive productivity to offset some of that pressure like we have historically, but we have factored that into our guidance. Further, we are seeing some cost pressure coming in from property taxes in certain states like California, so we factor that into our guidance. And, finally, because our capital spending is stepping up slightly year on year, there's a bit of expense associated with that. As you know, productivity is a virtuous cycle at the Home Depot. So we always try to do better.

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

Okay, thank you.

Operator

Seth Sigman, Credit Suisse.

Seth Sigman - ***Credit Suisse - Analyst***

Thanks, good morning guys. Congrats on the quarter. My first question is about Interline. I may have missed it, but what are you assuming for growth of that channel? And as you think about the integration, it sounds like the initial rollout of the catalog, that's gone well in the early testing. Can you give us a sense of what you've seen, maybe a lift or just the change in behavior as you have added that catalog to the store?

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

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

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

And we are excited about the opportunities with Interline. It is a $50 billion market opportunity across multifamily hospitality and institutional, which we own about 5% give or take of that market. So it's a significant opportunity for us to continue our share of wallet with our pro customer.

As you called out, we talked about the first use cases allowing our stores to purchase the Interline product. The next thing we are working on is allowing our Interline customers to be able to buy product through Home Depot or HomeDepot.com on their account. And that we're focused on here in 2017.

Seth Sigman - *Credit Suisse - Analyst*

Okay, I guess as a follow-up, you've discussed PFRI a lot over the years and the importance for your business. PFRI, it decelerated quite a bit in 2016, particularly towards the back half in year-over-year terms.

Obviously that disconnects with Home Depot's performance which accelerated. Do you think that is market share maybe tying in one of the earlier questions, or do you think the mix of the business is changing in a way that suggest perhaps the underlying drivers of your business are changing a bit too?

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

I think PFRI is a great indicator of the health of the overall market. And as you can see it is a healthy market. We are a big part of it, aren't we? Because improvement, if you look at the components of PFRI improvement is one of the big components and we are part of improvement. So in a way it is a bit circular. I'm not sure that it's a great predictive tool, but it certainly is a great indicator of the health. Now here is a really fun fact, and I know you know this because you've done all the research in this area, if PFRI were to return to the mean of 4.5% and GDP remains the same it would have to grow about 18.5%. And assuming there is no share shift for the Home Depot that's a $16 billion opportunity for us.

So will we get all those sales? I don't know, but it certainly suggests as the housing market continues to recover there is growth ahead for The Home Depot.

Operator

Christopher Horvers, JPMorgan Chase.

Christopher Horvers - *JPMorgan - Analyst*

Thanks, good morning. Question, on the cadence of the year how are you thinking about comps, you just blew through what was supposed to be a very difficult comparison and didn't have any impact at all. How are you thinking about the spring setup this year and then the overall cadence comps?

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

As you know we like to look at our business from a half and not a quarter because of what we call the bathtub effect. You are never really sure with spring will land. If we look at the split by half, we would expect the first half to be slightly lower than the back half of the year.

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

Christopher Horvers - *JPMorgan - Analyst*

That's excellent. On the gross margin, does the outlook reflect any slowing supply chain benefits or other pressures like ocean freight? And then related to that, inventories were flat in 2016, should we see expansion in 2017 with Project Sync?

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

So on the gross margin, we certainly are seeing some pressure from fuel year over year. And Mark Holifield is here and can comment.

But certainly we expect to see some of that pressure in the year. We will continue to get productivity through our supply chain, and then we will invest that back into the business.

Mark Holifield - ***The Home Depot, Inc. - EVP, Supply Chain and Product Development***

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

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

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

On the working capital front, we expect working capital to be a source of cash for the business in 2017. And we are planning for inventory turns to improve 2/10 year on year.

Christopher Horvers - ***JPMorgan - Analyst***

Thanks very much. Have a great spring.

Operator

Michael Lasser, UBS.

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

Thanks a lot for taking my question. Carol, can you just describe the thought process behind recalibrating the model that you used to predict your sales outlook for the year by adding a component based on the wealth effect?

Some the skeptics might argue that anytime you have to recalibrate your model this far into a cycle that might be a sign of the top. Especially when perhaps one could argue you are double counting the housing impact because you do have a housing component already and then if you had another that weights pricing.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

Well, first of all, I will say it's a minor change. About 4/10 of growth year on year. Secondly, our forecasting model is directionally correct, but at the beginning of 2016 it certainly didn't predict a 6.2% comp in the United States. So we use all these factors to build a model to give us a sense of where we are going.

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

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

That's helpful. My other question is on your gross margin outlook for the upcoming year, and really your promotional posture it seems like you are leaning in and taking advantage of some of the market share opportunities that are going to be afforded to you. But how do you balance between suppressing the profitability of the category and gaining your fair share? So you can lean in, be a little bit more aggressive on some of the promotions. But if that is what the customer is now conditioned to expect, you may never be able to get that profitability back even if you did pick up some market share in the process?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

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

Ted Decker - ***The Home Depot, Inc. - EVP, Merchandising***

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

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

One another data point if I may. If you look at sales by category peak to trough, while we have more than fully recovered everything we lost during the downturn we haven't recovered every category.

We still have $1.4 billion of sales that haven't fully recovered. And those are in low margin categories. We want that to grow and if housing continues to grow, it will.

Operator

Scott Mushkin, Wolfe Research.

Cody Ross - ***Wolfe Research - Analyst***

Hi, this is Cody actually on for Scott today. Thanks for taking our question. Your pro business continues to deliver exceptional performance. What is driving that performance and can you update us on some of the initiatives you are running?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

Bill and Ted can comment on the pro business.

Bill Lennie - *The Home Depot, Inc. - EVP, Outside Sales & Service*

This is Bill Lennie. Just a comment on pro activity. We are seeing a great balance between our low spend and our high spend pro.

Good health on the business being driven both by transactions, more transactions and tickets. So it just says that we've got great activity in the stores.

And as Ted said, the drivers for the pro are just in-stock and everyday value on the shelf. So it's just health across the business across multiple categories.

Ted Decker - *The Home Depot, Inc. - EVP, Merchandising*

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

Cody Ross - *Wolfe Research - Analyst*

Great, thank you. Many believe there is a lot of significant pent-up demand out there that will drive growth in housing in 2017 as you guys alluded to as well. However, rates are expected to rise.

Is there a rate that you guys begin to get worried? And how do you balance that pent-up demand versus the expected increase in rates? Thank you.

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

Our analysis would show that for every 25 basis point increase in mortgage rates it costs the homeowner who's applied for a mortgage $40 more per month. So that helps dimensionalize the pressure associated with rising rates. With a median home price in the country of $250,000, mortgage rates could go up to 7%-ish before the affordability index would fall at 100 or below. So there's a way to go before we'd be concerned. And mortgage rates stand today at 4.2%, 4.3%, something like that. The historical mean is 5.8%. So even if a return to the mean you are still below that inflection point.

Cody Ross - *Wolfe Research – Analyst*

Understood. Thank you very much and best of luck.

Operator

Dan Binder, Jefferies.

Dan Binder - *Jefferies & Co. - Analyst*

Great, thank you. Just sticking with pro for a minute, I know you've highlighted product value, credit delivery. I'm just curious, when you listen to the pro, how much of the advantage do you have really lies with the store base, the density of the store base, the convenience of the store base in the markets?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

There is pro business across all markets. We actually look at the penetration of our pro business on a store-by-store basis, and this isn't tied to a specific market. It's a broad-based approach that we've taken in the business candidly from the very beginning of Home Depot.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

We joke, we are pro.

Dan Binder - ***Jefferies & Co. - Analyst***

And then in a great quarter I hate to even bring it up but the shrink was up a bit. I was just curious if there was anything you would attribute to that?

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

I wouldn't read anything into shrink for the year. Shrink was up 1 basis point. This is just a year-over-year comparison.

Dan Binder - ***Jefferies & Co. - Analyst***

And then the last question if I could, given the strength in e-commerce, is there any implications on the profitability or profit headwind as the e-commerce business grows within the broader mix of the sales?

Craig Menear - ***The Home Depot, Inc. - Chairman, CEO & President***

As we have shared in the past, we actually think about this as one business. It's the way the customer thinks about it, and so we handle this from a portfolio approach and we looked at a blended operation because that's really where the customer is taking us with 45% of our orders being picked up in store.

Dan Binder - ***Jefferies & Co. - Analyst***

Okay, thanks.

Operator

Dennis McGill, Zelman and Associates.

Dennis McGill - ***Zelman & Associates - Analyst***

Good morning, thank you. Curious if you could elaborate a little bit on the flooring category. It's been an area I think just in general in home improvement that hasn't been very robust, and even within your relative performance and to see that as a double-digit category hoping you can maybe explain a little bit what was driving it?

Ted Decker - ***The Home Depot, Inc. - EVP, Merchandising***

Sure. You've heard us talk over the last several quarters about our investments in hard surface materials and those businesses continue to do very well with laminate, very strong.

We are getting great product innovation on vinyl flooring. So today's vinyl flooring is not the 50s and 60s kitchens laminate, or vinyl rather. So you're starting to see what is called luxury vinyl plank introduced into many use cases.
Tile continues to perform very well. But the thing that's really working for us right now is the soft side. You haven't heard us talk about the soft side in some time.

Our hard set has been doing great for several quarters. And we are now seeing the soft side pickup vary significantly, so we have both ends of that business working for us right now which is what produced the double-digit comps.

Dennis McGill - ***Zelman & Associates - Analyst***

And that acceleration, Ted, from third quarter to fourth quarter was on the soft side and was there any type of promotion or installed promotion driving that?

Ted Decker - ***The Home Depot, Inc. - EVP, Merchandising***

No, no promotion at all.

Dennis McGill - ***Zelman & Associates - Analyst***

And then Carol, on the capital spending plan of the $2 billion, in the grand scheme of things I guess it's not that much but up from $1.6 billion in 2016, how much of that is definitely coming through persisting some might be planned and could potentially be pushed out? Just want to make sure that's the right comparison, the $2.0 billion to the $1.6 billion.

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

The comparison is correct. We are planning to spend the capital that we are guiding to of $2 billion. It's about 2% of sales. And as you think about for our business going forward if you want to model 2% of sales I think that would be a good number to use. We are investing in the initiatives that we've shared with you be it interconnected retail, supply chain but we are also investing into our stores. As Craig pointed out, 45% of our online orders are picked up inside of our stores.

That means we need to do some reconfiguration to hold those orders to make sure the experience is right. We did a lot of work with our customers this summer and got some good feedback from our customers about things we could do differently in our stores. So 500 of our stores will be receiving what we call a new store environment, which is a wayfinding package, new lighting, the floors are going to be polished up, and the stores are relevant and we want to keep them that.

Dennis McGill - ***Zelman & Associates - Analyst***

Okay, that's helpful. And Carol, you mentioned a breach cost, I think, in the fourth quarter, is that right? And if so, do you have the number?

Carol Tomé - ***The Home Depot, Inc. - EVP, Corporate Services & CFO***

It was $11 million in the quarter, $37 million for the year, $298 million life to date. And I think we're done and we are happy about that.

Dennis McGill - ***Zelman & Associates - Analyst***

I appreciate it. Thanks guys, good luck.

Operator

Matt Fassler, Goldman Sachs.

Matt Fassler - *Goldman Sachs - Analyst*

Thanks so much. My first question relates to capital allocation. We, obviously, took note that both the dividend hike and the change in the payout ratio as well as the new buyback authorization.

Over the past couple of years, you've bought back more stop stock than you had initially guided to. Can you talk about whether the higher payout ratio would change your ability or inclination to do so, I guess if the price was right, of course, and also just remind us of the leverage targets that you are thinking about?

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

We've guided at the beginning of each year based on the cash flow projections that we have for the business. We still have a target of two times debt to EBITDAR ratio. That is something that our board is comfortable with, so it's possible that we could expand.

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

If you look at where the adjusted debt to EBITDAR ratio stands today, there is $2 billion of borrowing availability. It is not our intent to let that ratio decline which it will if we don't lever back up. The interest rate environment is still very attractive. We are very pleased with how we have utilized debt financing to supplement our cash to buy back shares. So we're certainly not suggesting anything is going to change off of our past practice.

Matt Fassler - *Goldman Sachs - Analyst*

Thank you for that. My second question relates to big-ticket in the fourth quarter. So this was the third straight year that your big-ticket comp was strongest in Q4, and, obviously, you've been putting up amazing multiyear comps in aggregate in Q4 but big-ticket seems to be the biggest driver.

If you would talk about other changes in your selling push or in buying patterns is it better traction of appliances, is it the pro push in Q4, is it marketing across a broad array of seasons? What is it that is driving your transactions over $900 to such a great degree in Q4 more so than over the rest of the year?

Ted Decker - *The Home Depot, Inc. - EVP, Merchandising*

Sure, Matt. I'd say, first of all, that what we really like in the business is the balance. So as Carol and Craig said our comp in the US stores was 6.3% in Q4, it was 6.2% for the year.

We have a balance of ticket and transactions in the fourth quarter. It was roughly 3% for each of ticket and transaction. We are getting growth in our small ticket, we are getting the growth that you are asking about in big-ticket and we are also seeing an increase in items per basket. So just that breadth of performance across the store we like very much.

What's driving the outsized gains for another quarter in big-ticket is really you named them. So we continue to drive the appliance business in the fourth quarter. Appliance has become a big selling period with traditionally the Black Friday period in retail.

Our flooring business that I talked about help drive that ticket. And then the broad strength of the pro across the entire store is the third large element driving that outsize comp in big-ticket.

Matt Fassler - *Goldman Sachs - Analyst*

Understood, thank you so much, Ted. Appreciate it.

Diane Dayhoff - *The Home Depot, Inc. - VP, IR*

Catherine, we have time for one more question.

Operator

Seth Basham, Wedbush Securities.

Seth Basham - *Wedbush Securities - Analyst*

Thanks a lot and good morning. My question is around SG&A, specifically labor optimization. You mentioned this in the past as a potential initiative for 2017. If you can provide an update on how you are thinking about it now that would be helpful.

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

When it comes to optimizing we are looking at that across multiple aspects of our business. We on occasion look at the structure within our business and we have organizational changes.

This past year, for example, we brought together our online and marketing teams because that's really the direction of where the business is going. So we are continually looking at how do we optimize and drive productivity within our business around the SG&A.

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services &* CFO

Certainly, Craig, you commented on what we are doing with freight inside the store.

Craig Menear - *The Home Depot, Inc. - Chairman, CEO & President*

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

Seth Basham - *Wedbush Securities - Analyst*

Got it. So as you look at the forecast for SG&A growth in 2017, does it contemplate much in the way of labor productivity savings?

Carol Tomé - *The Home Depot, Inc. - EVP, Corporate Services & CFO*

No material change to what you've seen in the past several years.

Seth Basham - ***Wedbush Securities - Analyst***

All right. Thank you so much.

Diane Dayhoff - ***The Home Depot, Inc. - VP, IR***

Thank you everyone for joining us today. And we look forward to talking to you on our first-quarter earnings call in May.

Operator

Thank you. Ladies and gentlemen, once again that does conclude today's conference. Thank you all again for your participation.