HD - Q3 2015 Home Depot Inc Earnings Call
EVENT DATE/TIME: NOVEMBER 17, 2015 / 9:00 a.m. EST

PRESENTATION

Operator

Good day everyone and welcome to The Home Depot Q3 2015 earnings call. Today's conference 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, man.

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

Thank you, Alan, 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 or investor relations department at 770-384-2387.

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

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

And 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. Sales for the third quarter were $21.8 billion, up 6.4% from last year. Comp sales were 5.1% from last year and our U.S. stores had a positive comp of 7.3%. Diluted earnings per share were $1.35 in the third quarter.

In the third quarter as we saw in the second quarter, we had a broad-based growth across our geographies. All three of our U.S. divisions recorded mid to high single-digit comps. Every region posted positive comps in the quarter as did all of our top 40 markets.

Year over year the variability in performance across our regions has narrowed considerably. On the international front our Canadian business posted positive comps in local currency making it 16 consecutive quarters of positive comps.

In addition our Mexican business had another quarter of solid performance with positive double-digit comps in local currency. This makes 48 quarters in a row or 12 years of positive comp growth for our Mexican business.

We saw growth in ticket transactions and average basket size in the third quarter and we were particularly pleased with a strong transaction growth as each month in the quarter had positive comp transactions. We view our growth and transactions as a positive sign of our continued relevance with our customers.

As Ted will detail, we continue to see strength across our store. All of our merchandising departments posted positive comps and we saw a healthy balance of growth among both our Pro and DIY categories. Our Pro business continues to be driven by a strong offering of brands that Pros demand; consistent product innovation as well as services that help them increase their business.

During the quarter we completed the acquisition of Interline Brands, a leading national distributor of maintenance, repair and operations or MRO products. This acquisition builds on our existing capabilities to serve our Pro customers. Interline gives us a national presence in the MRO market which will allow us to expand our share of wallet with our collective customers. We are diligently working on integration plans and are excited about the opportunities that we see ahead.

The retail environment has been and is changing. Our customers both Pro and DIY are changing the way they shop for our products and services. Our goal is to provide our customers with the convenient and fulfillment options they require.

Whether they buy products online through a personal computer, a tablet or their mobile phone we are enabling them to pick up product in our stores or have products shipped to their home. We are investing in making the process easier and frictionless.

We continue to see healthy sales from our digital business. Online sales grew approximately 25% in the third quarter and represent approximately 5.1% of overall sales. About 42% of all online orders are picked up in our conveniently located stores.

We rolled out Mexico's digital commerce site during the first half of the year and although we are just getting started we are seeing great results. In Canada we replatformed our website which went live earlier this month. Back in the U.S. we opened our third online customer contact Center in Tempe, Arizona. All this is a further sign of our commitment to interconnected retail in our geographies.

We continue to focus and invest in our supply chain to drive productivity and to deliver a better customer experience. As our customers are transacting more frequently through our online channels we have invested in creating the right fulfillment options to support that growing business.

During the third quarter we opened and began shipping from our third new direct fulfillment center in Troy Township, Ohio. With these three direct fulfillment centers we now have the capability to reach 90% of U.S. customers in two business days or less with parcel shipping.

As you know we have been piloting our new order of alignment system which we call COM as well as buy online, deliver from store or BODFS. We're really pleased with the results of the COM pilot and we have laid out a rollout plan for 2016.

The BODFS rollout will follow COM. In the 108 stores where we have BODFS our on-time delivery service is now exceeding our target. BODFS will also be rolled out in 2016.

Turning to the macro environment, while 2015 consensus U.S. GDP growth projections have moderated we continue to see positive signs in the housing data with home price appreciation and housing turnover being key drivers of growth for our business. As Carol will detail, we are guiding our fiscal 2015 sales to grow by approximately 5.7% with comps of approximately 4.9%. This is after the effects of a stronger U.S. dollar.

Year to date due to a stronger U.S. dollar our sales growth has been negatively impacted by over $1 billion. We believe that the U.S. dollar will remain strong through the fourth quarter. We are guiding fiscal 2015 diluted earnings per share to be $5.36, an increase of approximately 14% versus fiscal 2014.

Let me close by thanking our associates for their hard work, dedication and commitment to our customers. Based on this quarter's results 99% of our stores would be eligible for Success Sharing, our profit-sharing program for our hourly associates.

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 were pleased with our performance in the third quarter as sales exceeded expectations. We saw strength across the store as well as continued growth in our online business.

All of our merchandising departments posted positive comps. Appliances, tools, plumbing, decor, lighting, hardware, building materials and indoor garden were above the Company average.

Outdoor garden, kitchen and bath, electrical, millwork, flooring, lumber and paint were positive but below the Company average. Pro heavy categories continue to show great strength and we saw double-digit comps and power tools, commercial lighting, HVAC, fencing and power tool accessories. Additionally, flooring tools and materials, siding, concrete, fasteners, roofing, builders' hardware and compressors had comps above the Company average.

The core of the store continued to perform well across the country as we saw strength in maintenance and repair categories. Watering, water heaters, ceiling fans, air circulation, hand tools and generators all had double digit comps in the quarter. Wet drive VACs, wiring devices, pipe and fittings and ladders had comps above the Company average. There was also strengthened decor projects with comps above the Company average and special order window coverings, vanities, in-stock kitchens and fixtures.

Our Halloween and Harvest and Labor Day events provided great values and were well received by our customers, resulting in double-digit comps in decorative holiday, organization and appliances. Sales of grills, soils and mulches, pressure washers and cleaning had comps above the Company average.

Using our assortment planning tools our merchandising team constantly refines our assortments by bringing science to the art of merchandising. Recently we leveraged these tools to better understand the customer preferences in roofing.

We updated our roofing clusters to tailor our roofing brands to specific markets and customers and we introduced more high definition laminate shingles. This process yielded great results in the third quarter. By providing the Pro customer the right brand, assortment of value we drove double-digit comps and shingles.

Total comp transactions grew by 4.3% while comp ticket increased 0.9% for the quarter. Our average ticket growth is a bit distorted due to the stronger U.S. dollar. In the U.S. our average ticket was up 2.6%.

Finally, commodity price deflation in certain products such as lumber negatively impacted our average ticket increase by about 40 basis points. While lumber prices are down we were very pleased with unit growth.

Transactions for tickets under $50 representing approximately 20% of our U.S. sales were up 3.6% for the third quarter. Transactions for tickets over $900 also representing approximately 20% of our U.S. sales were up 7.8% in the third quarter. The drivers behind the increase in big-ticket purchases were appliances, roofing and countertops.

Now let me turn our attention to the fourth quarter. We recently introduced the new Husky 100 platform of mechanics tools for our DIY and Pro customers. This new platform put was designed with speed and access in mind.

These tools feature a 100 position gear system that allows the tools to work in tight areas where normal mechanics tools cannot perform. This new family of tools is exclusive to The Home Depot and offers a lifetime guarantee.

In the fourth quarter we were also pleased to introduce six new models of NuTone InVent bath and ventilation fans for our Pro customers. This easy-to-install fan have new features that allow for room site installation with no attic access required. Easy installation saves our Pro customers valuable time.

We have an outstanding offering of product in our gift centers for the holiday season and our best lineup yet in holiday decor. Our gift centers will feature an extensive assortment of hand and power tools including amazing values from Milwaukee, Makita, Dewalt, Ryobi, Rigid and Diablo. The gift centers will also feature an impressive lineup of tools and storage boxes from Husky.

In holiday décor we've become a leading destination in the category, both in-store and through our expanded assortment online. We continue to focus on bringing innovative and exciting offers to our customers throughout the holiday season. We are excited about our lineup of pre-lit and holiday lights.

For Black Friday we have fantastic special buys with extreme values for the traditional DIY customer and our professional customer, including some amazing offers on appliance suites. With all of these exciting products, events and great in-store execution we look forward to driving a strong holiday season.

With that I'd like to turn the caller to Carol.

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

Thank you, Ted, and hello everyone. Before I begin I'd like to remind you that this is the first quarter where we are including Interline Brands in our financial results. While the acquisition closed in late August our third-quarter results include one month of Interline as we are counting for Interline one month in arrears. Finally, while Interline results are included in our consolidated financial statements they are not yet included in certain operating metrics like comp sales, sales per square foot, average ticket or transaction.

So with that in the third quarter sales were $21.8 billion, a 6.4% increase from last year. Versus last year, a stronger U.S. dollar negatively impacted total sales growth by approximately $413 million, or 2%. Our total Company comp store sales store sales were positive 5.1% for the quarter with positive comps of 2.6% in August, 7.6% in September and 5.2% in October. Comps for U.S. stores were positive 7.3% for the quarter with positive comps of 4.6% in August, 10.1% in September and 7.1% in October.

Our monthly comp sales were a bit distorted by the timing of labor day this year versus last year. In the U.S. if you assume Labor Day fell in the same fiscal month as last year our comps were 6.9% in August, 7.8% in September and 7.1% in October. Our total Company gross margin was 34.7% for the quarter, an increase of 34 basis points from last year.

Our gross margin expansion is explained by the following. First, we had 24 basis points of gross margin expansion as we reached certain higher co-op and rebate tiers and recognized that benefit in our cost of goods sold. Second, we had 15 basis points of gross margin expansion in our supply chain due primarily to lower fuel costs and a higher penetration of products flowing through our RDC network. Third, we had 5 basis points of gross margin expansion from lower shrink. These three items drove gross margin expansion of 44 basis points, offset by 10 basis points of gross margin contraction due to the impact of Interline.

For fiscal 2015 we continue to expect our gross margin rates to be about the same as what we reported in fiscal 2014. In the third quarter, operating expense as a percent of sales decreased by 88 basis points to 21%. Total operating expenses were approximately $14 million higher than our plan, driven by expenses related to our data breach.

In the third quarter we incurred $20 million of legal and litigation related expenses in connection with our data breach. In the third quarter our expenses grew at approximately 33% of the rate of our sales growth, reflecting solid expense control and sales leverage.

For the year we expect our expenses to grow at approximately 47% of our sales growth rate. Our operating margin for the quarter and for the first nine months of fiscal 2015 was 13.7%. Interest and other expense for the third quarter was $240 million, up $127 million from last year.

The year-over-year change reflects two items. First, interest in investment income decreased by $90 million as we lapped last year's $100 million gain on sale of HD Supply common stock. Second, interest expense increased by $29 million from last year due primarily to higher long-term debt balances.

In the third quarter our effective tax rate was 37.1% and we expect our income tax rate to be approximately 36.5% for the year. Our diluted earnings per share for the third quarter were $1.35, an increase of 17.4% from last year. The strength of the U.S. dollar negatively impacted earnings per share growth by about $0.03 in the quarter.

During the third quarter we opened three new stores in Mexico for an ending store count of 2,273. Total sales per square foot for the third quarter were $366, up 5.3% from last year.

Now turning to the balance sheet, at the end of the quarter inventory was $12.5 billion, up $487 million from last year. On a currency neutral basis inventory dollars grew by $721 million of which approximately $324 million was the result of the Interline acquisition. Inventory turns were 5 times compared to 4.8 times last year.

Payables were up $339 million from last year. On a currency neutral basis payables were up $466 million including $134 million of Interline payables.

Moving to our share repurchase program, in the third quarter we received 1.3 million shares related to the true-up of an accelerated share repurchase or ASR program we initiated in the second quarter. Additionally, in the third quarter we repurchased approximately $2 billion or 15.1 million of outstanding shares. This included 5 million shares repurchased in the open market and 10.1 million shares repurchased through an ASR program.

For the shares repurchased under the third-quarter ASR program this is an initial calculation. The final number of shares repurchased will be determined upon completion of the ASR in the fourth quarter. For the remainder of the year we intend to repurchase approximately $2 billion of outstanding stock for a total fiscal 2015 share repurchases of approximately $7 billion.

During the quarter we raised $1.5 billion of senior notes to finance the Interline acquisition. We now have $20.9 billion of long-term debt of which $3 billion comes due on March 1, 2016. We plan to refinance that debt prior to it coming due. Computed on the average of beginning and ending long-term debt and equity for the trailing four quarters, return on invested capital was 26.2%, 400 basis points higher than the third quarter of fiscal 2014.

And moving to our guidance because we are nine months through the year and because we don't think the U.S. dollar is going to weaken we are providing a point estimate for our sales, comp sales and diluted earnings per share growth guidance. We now believe that fiscal 2015 sales will grow by approximately 5.7% with comps of approximately 4.9%. Our sales and earnings per share growth guidance is higher than the low end of our previous guidance as it includes our third-quarter out-performance and continued momentum in the U.S.

Our guidance also assumes foreign-exchange rates remain at current levels through the fourth quarter. We estimate a stronger U.S. dollar will impact our total sales growth for the year by approximately $1.4 billion.

For earnings per share remember that we guide off of GAAP. For fiscal 2015 we project our diluted earnings per share to grow approximately 14% to $5.36. This earnings per share guidance assumes foreign-exchange rates remain at current levels through the fourth quarter and includes our intent to repurchase approximately $2 billion in additional shares in the quarter.

So we look forward to talking with you at our Investor Conference on December 8 where we will update you on key strategic initiatives and layout our new three year financial targets. So we thank you for your participation in today's call. And Alan we are now ready for questions.

QUESTION AND ANSWER

Operator

(Operator Instructions) Simeon Gutman, Morgan Stanley

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

Thanks, good morning. Nice quarter. First question on the gross margin drivers I guess for Carol or Craig can you talk about the sustainability, I don't know if they are one-time items, the supply chain piece could be more sustainable, some of the lower acquisition costs, I don't with its one-time or there should be some recurring element to them?

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

Well, we're very pleased with our gross margin performance in the quarter starting with the benefits that we saw from co-op in rebate. This was effectively reaching higher purchasing tiers in certain categories like roofing and as Ted described we just had an outstanding roofing business. As we look into the fourth quarter roofing can be impacted by weather of course but we would envision that that performance would continue.

Supply chain we would expect to have continuing benefits from our supply chain as our RDC network continues to mature. I will say, however, as you are building your models for the fourth quarter we do expect year-on-year for our gross margin to be down.

Why? Because we will be selling a lot of lower margin goods as Ted described in his remarks.

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

Got it. Then one follow-up on expenses.

The business did a great job once again and you held the line despite some of the increased volumes. Can you talk about how much is the economic model that exists in stores versus things that are behind the scenes that we don't see like some corporate or indirect savings that you continue to realize?

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

Well thank you. We were pleased with our expense leverage in the third quarter. Marc Powers and his team do an awesome job of making sure that our stores are staffed to meet the needs of our customers.

Our voice of customer results have never been higher while also driving productivity within the hourly salesforce. So hourly payroll leveraged 41 basis points in the quarter. But it's more than just payroll.

Marc again and his team have invested in new technology to lower the cost of heating and cooling our stores and utilities were down year on year and drove 6 basis points of benefit in the quarter. While we had breach expense in the quarter we had $8 million less breach expense this year than last year, so that was another driver of expense. For us productivity is a virtuous cycle and you see that in the third-quarter results.

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

Okay thanks.

Operator

Christopher Horvers, JPMorgan.

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

Thanks, good morning. Just a quick follow-up on the gross margin. Is the other piece around the fourth quarter because of Interline will be a 30 basis point headwind versus the 10 in the third quarter?

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

Yes, thank you for mentioning that. We will have three months of operation of Interline in the third quarter. The Interline gross margin as you probably have seen by looking at their public financial information their gross margin is lower than ours.

So that will be an impact to year-on-year performance. I will also comment, however, that Interline's operating expenses as a percent of sales are lower than ours, so we won't have an expense pressure from Interline in the fourth quarter.

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

Understood. And then on the Craig, you mentioned a comment about the narrowing of the performance gap across geographies.

Some thoughts on what you're seeing there, what geographies I guess are catching up to the average? Any comments on the Houston market and any other commentary you want to add there would be great. Thanks.

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

I will start with Texas. We have roughly 178 stores in Texas. We look at all the major markets in Texas and they actually performed above the Company average in total.

The narrowing of variability by markets, it was roughly the spread was roughly 6.5% in 2015 compared to 10.4% in 2014. So we are very very pleased as we work to continue to focus on high and narrow variability and drive performance up across the geographies.

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

Okay. And then I guess a question on everybody's here topic which is weather.

How should we think about El Nino and how it could impact your business over the next couple of quarters? Does it pull forward demand into 4Q?

I think I recall in 1Q 2012 people could do roofs in the Northeast in January because it was so warm but on the other hand you have a big home heating and snow removal exposure in 4Q. So how do you think it plays out, does it neutralize, does it pull forward and so forth?

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

It really depends on obviously how this plays out. It could potentially play to a warmer northern which means we might have a year where we have more outdoor project business running deeper into the season. The potential offset to that is a much cooler, wetter southern situation.

So it really depends on how this plays. We'll be in position as we always are to try to make sure we take advantage of whatever categories will be the drivers in the different geographies. And then with any luck it brings rain to California which is desperately needed.

Christopher Horvers - *JPMorgan - Analyst*

Understood. Thanks very much.

Operator

Seth Sigman, Credit Suisse

Seth Sigman - *Credit Suisse - Analyst*

Thanks, hey, guys that morning. Just a follow-up on the gross margin outlook, you discussed the mix impact and the Interline impact. Just wondering if you could talk a little bit about the promotional activity that you're seeing in the industry and whether there's any meaningful change heading into the holiday in some of the more relevant categories like appliances?

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

This is Ted. We're essentially the same year over year in our promotional cadence, so there won't be a net impact from promotions.

Seth Sigman - *Credit Suisse - Analyst*

Okay, thanks. And then as you look at the Pro side of the business for a strong trends there. Wondering if you could update us on the $6,600 average Pro spend that you've seen historically.

Obviously that captures a wide spectrum with some customer spending a lot more. When you guys dig into the data where are you seeing the growth? Is it from existing big spenders within that or is it just kind of broad-based across the group?

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

We haven't seen a meaningful change in the total average customer spend. We are seeing that growth come from our larger Pro customers and we've seen that trend for the past several quarters now.

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

So if we look at our managed accounts and those would be large spend Pros, they grew faster than the Company average in the third quarter.

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

Okay, great. Thank you.

Operator

Dan Binder, Jefferies.

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

Hi, good morning. Ted I was hoping you could maybe talk a little bit more about your initiatives on merchandising by store.

You've given some examples in the past, I think water heaters this quarter, you talked about roofing. Can you give us a little bit of color on where we are if there was a nine inning game are we still in the early innings or middle innings?

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

I would say it's always hard to put it into innings. I would say our tools are maturing nicely, those are mid-innings for sure and then the merchants utilization and the whole change management and speed of how we review categories and ultimately get the refreshed product set in the store is our new focus area.

And we're aiming to increase the speed of transitions of product in the store. That's in earlier innings but in terms of the tools we're getting pretty well developed there.

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

Our investor conference in early December, Ted will go into more detail here.

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

Okay, Carol, I don't think anybody ask yet but just relative to your fourth-quarter plan how are you feeling about things to date?

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

There's a lot of momentum in the U.S.

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

Okay. Do you think weather helped you at all just in the third quarter?

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

Weather, as we talked earlier weather is a factor in our business whether it is in a particular category. Clearly with warmer weather you're not selling a lot of the winter categories right now but time will come on that. And so you do get an advantage in outdoor projects when the weather stays better.

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

Great. Good job. Thanks.

Operator

Brian Nagel, Oppenheimer.

Brian Nagel - ***Oppenheimer & Co. - Analyst***

Good morning. Congratulations on a very nice quarter.

The question I had, I guess it's mostly for Carol, Ted maybe too, we talked about before just kind of an update given a lot of the headlines we're seen from other retails and data in general. But what you are seeing with respect to wages and maybe some pressure, any potential pressures upon the Home Depot model from higher wages in your system?

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

We like every other Company are looking at what's happening with the wage market. And in parts of the country where there's high employment and there's wage pressure we adjust. But we are able to work through that through the great productivity model that we have in our stores.

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

We will continue to adjust market by market as we see the dynamics of each market unfold.

Brian Nagel - ***Oppenheimer & Co. - Analyst***

Okay, that's very helpful. Then any, I know it's early and I'm sure you'll discuss this more a lot more at your December meeting but any initial thoughts on Interline? Now that the transaction is closed any initial findings or thinking about how this is going to meld into the Home Depot model?

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

Well we're in the very early stages of integration and we're working through that. We're excited about the opportunity. We know that there is an overlap with our vendor community and we will get synergies from that and are beginning to get synergies already.

We also know that we've taken our first actions on a little bit of the reorganization of folks where we have duplicate efforts that we don't need going forward. So we're in the early stages but we're excited about the opportunities that we see.

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

And if I could just add a comment from the macro perspective we saw household formation up 1 billion households formed in the third quarter. Many of those households will be moving into multifamily units. The Interline acquisition gives us a great selling vehicle to serve that new household if you will.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Got it. Thank you and congrats again.

Operator

Aram Rubinson, Wolfe Research

Aram Rubinson - *Wolfe Research - Analyst*

Hey everybody good morning. Thanks for letting me ask the question. Your Company has gone through a history of acquisitions where the pendulum has swung one way and then the other.

You were doing a whole lot of acquisitions in the early 2000s and then of course you just kind of shut it down. Now you're swinging back the other way.

I'm trying to figure out where that pendulum feels comfortable organizationally. Is it halfway in between where you have been or are you preferring to stay towards the conservative side?

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

What we said is that we will look at acquisitions where it gives us the ability to gain capabilities that we might not want to go build ourselves. So if you think about some of the acquisitions that we've done, the Black Locus acquisition gave us a data science capability that's being leveraged by our merchants for assortment and price.

If you think about the Crown Bolt acquisition that was basically accompany that was built for us that we sold when we sold HD Supply. We got it back. That gives us different distribution capabilities for small package goods in our stores.

The Interline acquisition gives us the capability to better serve our Pro customer through things like open account, through 93 points of distribution where we can deliver same day, next day. So this is all about how to we actually get capabilities. Beyond that really not looking for acquisitions.

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

Right so you might think, well, do you need to buy marketplace. We can build that.

Do you need to buy a services Company? No, we have one. So those are capabilities that we don't need to acquire.

Aram Rubinson - ***Wolfe Research - Analyst***

Thanks. And then just to follow up I know that in order to prepare for the future you've migrated some categories out of stores, at the margin patios, grills, etc. figuring you can sell that online and devote other space to some other new categories. Where does appliances fit into that mix in terms of migrating them out of the store versus in the store?

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

I would say on that we already have a model that leverages a nice interconnected complement of displaying the product in the store but then delivering direct from our manufacturers' warehouses. So we're leveraging an interconnected model from the day we developed our appliance model.

Aram Rubinson - ***Wolfe Research - Analyst***

Already show rooming then. Well thank you and good luck this quarter.

Operator

Jaime Katz, Morningstar.

Jaime Katz - ***Morningstar Equity Research - Analyst***

Good morning, thanks for take my questions. I'm curious if you guys could comment on capital allocation policy? And outside of share repurchases what other opportunities you guys are seeing to deploy capital and maybe to focus on either a product or merchandising innovation in light of the fact that shares have run up pretty robustly over the last few years?

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

We had a disciplined and balanced approach when it comes to capital allocation. The first use of cash is to invest it back in the business. This year we'll spend about $1.6 billion of capital back into the business supporting our growth.

We then take our excess cash and first pay 50% of our earnings in the dividend. And the way that works is at the end of the year we will look at how much we've earned and we will cut it in half and that will be the new dividend. If there were ever to be an earnings disruption we wouldn't cut the dividend, we would just earn back into that 50% payout.

And then excess cash is used to repurchase shares. We think that's the best use of excess cash rather than leaving it on the balance sheet which would be value diluting to our shareholders.

We do have an adjusted debt to EBITDA target of two times. We're at that ratio right now. So we have used the financial leverage judiciously both the support acquisitions as well is to buy back our shares.

As it relates to evaluation of our share price we do have a point of view. We're not at that intrinsic value, so we continue to outperform and that intrinsic value continues to increase.

Jaime Katz - ***Morningstar Equity Research - Analyst***

Okay. And then I think you made some additional commentary on spent for the data breach. Do you guys see those expenses wrapping up over the next quarter or two or is it still sort of to be determined?

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

There are ongoing legal fees as well as litigation activities. We estimated another $5 million of expense in the fourth quarter but there could be more. None of it would be bigger than a bread box.

It's all manageable. The biggest numbers that we had were the numbers that we settled on the payment card networks in the second quarter.

Jaime Katz - ***Morningstar Equity Research - Analyst***

Thank you very much.

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

And bigger than a bread box is not a financial term.

Operator

Seth Basham, Wedbush Securities.

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

Good morning and thank you for taking my question. My first question is around the consumers' behavior in the store in terms of trading up. Are seeing more activity of consumers trading up to premium products?

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

I wouldn't say it's any more dramatic than we've talked about before. But we do look at sales by price point. And again this quarter we had a progression of higher comps as you went up price points in an assortment.

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

Got it. That's helpful color. And as it relates to the Pro can you give us a sense of how much better the Pro is comping relative to the DIY customer and whether or not that gap has increased or decreased over the last few quarters?

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

Our large spend Pro as Carol mentioned earlier is actually comping above the Company average and that's been a driver certainly in our Pro recovery. That hasn't changed dramatically in the last few quarters. It's been pretty consistent.

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

Got it. And you look forward when you think about all the services and brands you're offering to the Pro and the macro environment do you think that type of gap can persist or would you expect it to increase?

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

We would certainly expect it to continue.

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

Thank you very much.

Operator

Mike Baker, Deutsche Bank.

Mike Baker - ***Deutsche Bank - Analyst***

Hi, thanks guys. A couple of questions.

One, the industry data that a lot of us look at, the NAICS data has been very reliable indicator for your comps historically, although the last couple of quarters you guys have far outpaced that data at really an accelerating pace. Do you see that as taking incremental market share and if so where do you think you're taking it from?

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

If I could just jump in on the market share, the census data, the NAICS score for one would suggest that we have grown market share.

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

And again we compete in with a lot of folks across each of our product categories. It varies widely by product category, whether that's other big-box, whether it's wholesale distributors, whether it's digital competitors. So we are very focused category by category as to where are the largest opportunities to grow our business and take share.

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

And that share on a rolling 12 through September was 56 basis points up.

Mike Baker - ***Deutsche Bank - Analyst***

Got it. Understood. One more question I wanted to ask, just on the really strong comp last year, could you remind us if weather did play an impact on that?

And what I'm getting at is really harsh winter up here in the Northeast, how much did that help or perhaps hurt the comp last year and how should we think about that as we cycle against it? For instance roofing, everyone I know up here in Boston had a leak in the roof. I assume your roofing business is still being helped by what happened last winter.

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

Sure. And I think that's the key is that based on the weather and we did have impacts from weather last year it then impacts categories differently from a timing standpoint.

So as you mentioned tough winter last year in the Northeast, certainly as you get into the spring you see people making repairs on things like roofing and then in some cases a lot of live goods needed to be repaired as well. But then that obviously is offset by categories. If it's a warm winter nobody's doing -- you're doing outside projects and nobody was doing that last year. So those are the dynamics category by category that affect our business, particularly as it relates to the start of spring and then through the tail end of the winter season.

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

But just as I said over time weather normalizes. And if you look at our U.S. comp on a two-year stack basis we see an acceleration from Q1 to Q2, Q2 to Q3 and now with the guidance I have just given you that acceleration into Q4 as well.

Mike Baker - ***Deutsche Bank - Analyst***

Understood. Okay, we all learned the term ice dam and roof rake up here in New England last year.

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

It was a tough winter.

Mike Baker - ***Deutsche Bank - Analyst***

Thanks.

Operator

Matthew Fassler, Goldman Sachs.

Matthew Fassler - ***Goldman Sachs - Analyst***

Thanks a lot and good morning. My first question relates to big-ticket projects which continue at a very nice clip. Anything in the business that gives you leading indicators as to project-oriented business whether it's people looking for bids, taking samples, etc., on some of the more project-oriented categories?

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

I think as Ted mentioned while we had pressure from deflation and lumber we were very pleased with our unit productivity and pleased with what we saw in our Pro business and as we said the larger spend Pros leading the pace there above the Company average. That clearly those lean to bigger ticket projects in the building materials business, bigger ticket projects, so we're very encouraged by that spend with the customer.

Then likewise you look at categories like appliances that's a big ticket spend as well. So we don't really see a slowdown if you will big-ticket.

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

And Matt if I can add from a macro perspective as we look at home equity lines of credit they are down 29% from the peak but 17 million home equity lines have been planted this year and 28% of the banks who are underwriting those lines of credit are stating that their underwriting is starting to ease a bit.

So if you think about people use their home equity lines that typically goes into a bigger project like a kitchen remodel or sort of thing. So it's a bit encouraging as we think about Q4 and beyond.

Matthew Fassler - *Goldman Sachs - Analyst*

Thank you. And then a quick follow-up, Craig you spoke earlier about the reality that retail is changing, consumers are shopping differently and your online business continues to grow nicely though it is still only 5% of the mix. How do you guys think about in the long run operating margin implications of this?

And you think about the amazing flow-through you've had the very modest expense growth relative to sales, I know that this will look pretty slowly for your just because of the role in the business even as it grows rapidly. And I'm not sure if it's possible to think about the incremental margin on the transaction delivered versus picked up in store or shopped without any e-commerce intervention. But as you look at the next two or three years you might tackle this a bit in early December how do you think about the role of omni-channel in impacting your financial model?

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

So the way we look at it quite candidly is as one business and an interconnected approach. A couple of things, one we shared with you that we did what we call COGS A, so we looked at normalizing how we account for things in both channels so that our merchants have a common view of all costs and expenses. And then as I mentioned earlier 42% of our online orders are picked up in our stores.

So it's very much a blended mix and we look at it as a blended mix and so we see it more of the same going forward. And we'll probably provide a little bit more outlook as we go into our December Investor Conference in terms of how the business is coming together by channel. But certainly view it as one Home Depot for the customer.

Matthew Fassler - *Goldman Sachs - Analyst*

Thank you.

Operator

Kate McShane, Citi.

Kate McShane - *Citi Research - Analyst*

Good morning. I was wondering if I could follow up on the e-commerce questions, with the opening of the third fulfillment center how do you view the actual store as a fulfillment center? And are you looking to use anything like Instacard or Google Express as a way to further your omni-channel experience?

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

I will just say that we do a lot of deliveries from store today. But Mark Holifield is here, I will let him comment on this.

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

Our stores have been a base for delivery for quite some time where we take orders in the store and deliver them. This buy online, deliver from store initiative that we have rolling in 108 stores now and we will roll out in 2016 allows us to take orders online, drop them to the store and use those same delivery assets to get to our customers.

We continue to stay abreast of the various offerings in the marketplace. We think the most important thing for us to focus on right now is our deliver from store initiative, utilizing the assets that we have in place now.

Kate McShane - *Citi Research - Analyst*

Okay. And if I can just follow up on that question, have you seen any meaningful change in the consumer behavior with regards to again mobile shopping or shopping through the website sequentially, so a meaningful change from Q2 into Q3?

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

No, not really. We've grown pretty comparably quarter to quarter.

Kate McShane - *Citi Research - Analyst*

Thank you.

Operator

Michael Lasser, UBS.

Michael Lasser - *UBS - Analyst*

Good morning. Thanks for taking my question. We've seen the spread between your same-store sales in the category expand for a couple quarters now.

So can you tie your share gains to specific categories that you've invested in? Or do you think it's coming from the expense of some competitors who are experiencing turbulence as a result of self-inflicted wounds? Or alternatively could we just be at the point in the cycle where the incremental consumer who's coming into the home improvement market is more compelled to go to the big-box on center channel?

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

Do you want to start Ted?

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

I would start on the investment piece first. Absolutely we seat terrific productivity in the areas that we have invested. And from what we can track we believe we're taking share in these areas and I'd highlight three.

One would be the lithium-ion battery technology in power tools and now migrating to outdoor power. We have an extremely robust lineup of brands and product and values in power tools and believe we're taking meaningful share there.

LED in light bulbs and now increasingly integrated into light fixtures where we've been very aggressive following the development of that technology. We were partnered with some of the best folks in the industry and our light bulb and now again integrated fixtures with LED are very strong. And we believe we're taking share.

Then in appliances certainly, you know we've been expanding square footage for some time now, investing into floor space and adding some additional brands to our portfolio there. We saw double-digit comps in appliances yet again this quarter and believe we're taking share in appliances.

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

And to your question about where are we on the cycle, we're doing a lot of work in this regard trying to come up with our own point of view. But one thing we've learned looking at data coming out of the Harvard Joint Center for Housing Studies as well as John Burns Real Estate Advising Firm is that homes that are older than 45 years tend to be have a higher repairs.

And in fact the amount of money spent on repairs in those older homes is 5.6% higher than the amount of money paid to repair a home that is 20, 24 years old. There are 40 million homes in the United States that are older than 40 years. So as the housing stock ages it just bodes very well for big-box home improvement retailers to sell to those customers who need to make repairs in their homes.

Michael Lasser - *UBS - Analyst*

Carol, do you have any insight into whether someone who lives in an older home would have a greater propensity to go to a big-box store versus some other retailer like a specialty player?

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

We don't have that kind of insight. But we will continue to study it.

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

And what I would say on that is the merchants will continue to focus on products that make it easier for our Pro as well as our consumers to be able to do those kind of projects.

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

Okay. And Craig, you've been very careful on the call to categorize your large Pro spending customers as outperforming the overall business. What about the Pro business in totality versus the rest of the business?

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

Our Pro business in total is good whether it's as Carol mentioned managed accounts, whether it's our consumer credit card data that shows, our Pro credit card data that shows. We've lost some visibility in the small Pro with our data breach that we're working to regain, so that's probably why we don't talk as much about our smaller Pro. But all of the data points that we have indicate that our Pro business is very solid and we're pleased with the results, whether that's within categories or whether it's at customer data that we have specifically.

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

To put some numbers behind it, if you just look at Pro sales on our private label credit card as well as managed accounts we know those sales. They make up 20% of our sales in the third quarter and they grew faster than the company.

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

My last question you fully anniversaried the data breach from a year ago. Do you think, as you look back now do you think that the breach had any impact on traffic in stores in light of how strong traffic was for this period?

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

It's really, really hard to tell. Clearly if you think back a year ago on our call we talked about the fact that we were pleased that each month had positive transaction growth despite the breach.

We again some positive transaction growth. As Carol mentioned just a minute ago when you look at a two-year stack comp basis we've seen progression in two-year comps quarter after quarter after quarter and we anticipate that we will be able to do that again this quarter. So it's really difficult to get at that number.

The only other thing I can tell you is as we said last year we know that there are customers who were upset based on the emails that we got. So there had to be some impact, it's just really hard to quantify.

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

Understood. Thank you so much and have a good holiday.

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

Alan, we have time for one more question.

Operator

Scot Ciccarelli, RBC Capital Markets.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

I believe you guys saw a bit of a slowdown in some of the energy heavy markets in Canada maybe nine months, 12 months ago or so but after entry prices turned down. So I guess the question is are you surprised you haven't seen more of an impact in some of the energy heavy markets in the U.S. and what would those differences be?

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

It's something that we were watching very, very carefully and certainly thought we might see some impact. But candidly Texas would be the biggest market that would have those kind of impacts.

We really haven't seen it at all. As I mentioned earlier all of our major markets in Texas actually outperformed the Company average comps and we've seen strength across the store.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

And then I guess the last question since this is the last question on the board here, Carol any update on the extended terms test for the Pro customer? I thought we were expected to hear something about that sometime in the fall timeframe?

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

You are going to hear all about it on December 8.

Scot Ciccarelli - *RBC Capital Markets - Analyst*

Got you. All right, thanks a lot, guys.

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

Thank you for joining us today. And we look forward to speaking with you at our investors and analysts conference next month.

Operator

That does conclude today's call. We thank everyone again for their participation.