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LOW.N - Q1 2022 Lowe's Companies Inc Earnings Call

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OVERVIEW:

Co. reported 1Q22 sales of \$23.7b and diluted EPS of \$3.51. Expects 2022 sales to be \$97-99b and diluted EPS to be \$13.10-13.60.

CORPORATE PARTICIPANTS

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

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PRESENTATION

Operator

Good morning, everyone. And welcome to Lowe's Companies' First Quarter 2022 Earnings Conference Call. My name is Kevin, and I'll be your operator for today's call. As a reminder, this conference is being recorded. I will now turn the call over to Kate Pearlman, Vice President, Investor Relations. Please go ahead, Kate.

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

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

I would like to remind you that our notice regarding forward-looking statements is included in our press release this morning, which can be found on Lowe's Investor Relations website.

During this call, we will be making comments that are forward-looking, including our expectations for fiscal 2022. Actual results may differ materially from those expressed or implied as a result of various risks, uncertainties and important factors, including those discussed in the risk factors, MD&A and other sections of our annual report on Form 10-K and our other SEC filings.

Additionally, we will be discussing certain non-GAAP financial measures. A reconciliation of these items to U.S. GAAP can be found in the quarterly earnings section of our Investor Relations website.

Before we turn to our first quarter results, I would like to announce that we will be hosting an Analyst and Investor Conference in-person on Wednesday, December 7, from 8:00 a.m. to 1:00 p.m. Eastern Time in New York City. For those of you who are unable to attend in-person, the event will also be live-streamed on video. At this event, our executive leadership team will provide updates on the key growth initiatives in our Total Home strategy and our long-term financial targets.

With that, I'll turn the call over to Marvin.

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

Thank you, Kate, and good morning, everyone.

In the first quarter, our total company comparable sales declined 4% with the U.S. comps down 3.8%. Excluding our seasonal category, sales were in line with our expectations for the first quarter.

Looking at sales goals on a 2-year basis, total company comps and U.S. comps were up approximately 20%. In Pro, we delivered growth of 20% and 64% on a 2-year basis. We also saw solid DIY demand for core nonseasonal home improvement projects. However, we experienced a delayed spring selling season due to prolonged unfavorable weather that impacted spring-related categories.

In fact, to put this into historical context, the past April was the coldest in over 20 years and one of the wettest in recent memory. But now spring has finally arrived, and we are seeing the anticipated improvement in our seasonal sales in the month of May.

I would like to provide some perspective on the impact that a very delayed spring has on our do-it-yourself or DIY sales. As a reminder, roughly 75% of our sales are to the DIY consumer in many seasonal categories like live goods, outdoor power equipment, grills and patio furniture are more heavily concentrated in DIY. And while spring was delayed across all geographies, the season came particularly late in the north, where sales were down double digits in many of our northern markets. And at the same time, sales in our Florida, Charlotte, Nashville, Houston, Atlanta, Dallas and Richmond regions were ahead of our sales expectations, even though spring weather was unfavorable in those regions as well. Simply stated, the further north you look, the larger the negative impact to our seasonal categories.

Although the late spring postponed our DIY sales, our Pro customers continue to shop to fuel their strong business demand. And our recent Pro surveys indicate that the majority of our Pro customers continue to report strength in their business and a full slate of projects for the year. At Lowe's, we see spring as a first half event. And as I mentioned, we are encouraged by the improved sales trends we're seeing in the month of May. We're also ready to capitalize on the increased demand with our enhanced assortment, strong inventory position, improved supply chain capabilities and seasonal staffing in place to serve our customers. Later in the call, Bill will discuss our plans to win spring again this year, while Joe will discuss how we are serving our customers during this busy season.

Importantly, our Total Home strategy has given us the agility and flexibility to deliver operating margin improvement even when sales decline. During the quarter, operating margin expanded approximately 65 basis points, leading to diluted earnings per share of \$3.51, which is an increase of over 9% versus last year. These results reflect great operational discipline in addition to excellent execution in a number of key initiatives, including our enhanced labor management tools, our perpetual productivity improvement or PPI initiatives, and our improved pricing capabilities.

Our Total Home strategy also enabled us to win with both the Pro and DIY customer in Q1 as we elevate our product assortment and provide our customers with the products and brands that they need across all of their home improvement projects.

Let me now discuss the progress that we're making with our Pro customer. As I mentioned, we delivered Pro growth of 20% in the quarter on top of 36% comps last year. The progress with this very important customer is reflected in the nearly 600-basis-point increase in Pro sales penetration in the U.S. from approximately 19% in Q1 of 2019 to approximately 25% in 2022. Later in the call, Joe will discuss how we continue to drive growth in Pro with the early success of our Lowe's MVP's Pro Rewards and Partnership Program that was launched in the first quarter.

On Lowes.com, sales grew 2% on top of over 36% growth in the first quarter of 2021, which represents a 2-year comp of over 39% and nearly 10% sales penetration. As we enhance our omnichannel offering, we are gaining traction with consumers who increasingly expect a fully integrated shopping experience. We're also expanding our market delivery strategy by adding other big and bulky products in Florida including patio, grills and riding lawn mowers to the appliances that we already deliver from our cross-dock terminals. By adding these incremental products, we're better leveraging our fixed costs while enhancing customer service at the same time. We've also converted our fourth geographic area, the

Tennessee, Kentucky region to this new delivery model. And we're on track to convert our full portfolio of stores to market delivery by the end of 2023.

Turning to our results in Canada where our performance lagged the U.S. in Q1. Last year, Canada's results benefited from record high lumber prices due to the higher lumber mix in our Canadian business.

In closing, despite some increased uncertainty in the macro environment, our long-term outlook for the home improvement industry remains positive. Homeowner balance sheets are very strong, and their confidence to purchase big-ticket items is supported by continuing home price appreciation. Other factors like the extension of remote work, the age of the housing stock, millennial household formation and baby boomers preference to age in place, all are long-term tailwinds for home improvement.

And over the past few years, we have greatly improved our operating capabilities so that we now have the agility needed to respond in this dynamic macro environment. These enhanced capabilities will allow us to continue to take market share while expanding our operating margin.

And as a reflection of Lowe's' commitment to the community, at the beginning of the year, we announced a new community impact program called Lowe's Hometowns. This is a 5-year \$100 million investment to improve the communities in which we live and work and to ensure we remain committed to giving back to our customers.

And before I close, I would like to welcome Brandon Sink to his new role as EVP and Chief Financial Officer. Brandon brings tenure, home improvement expertise and strong financial and operational acumen to this role, and we're excited to have him on the executive leadership team. I would also like to take a moment to thank Dave Denton for the contribution he made as CFO in the past 3 years.

And at Lowe's, we believe that our store associates are a competitive advantage, and I would like to close by thanking our frontline associates for their hard work and dedication.

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

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

Thanks, Marvin, and good morning, everyone.

In the first quarter, U.S. comparable sales declined 3.8%, but were up 19.7% on a 2-year basis. This quarter, we delivered a strong positive comp in building products, driven by our momentum with the Pro, while sales in home decor came in above our expectations driven by solid DIY demand. However, comps and hardlines were down compared to prior year as a delayed spring season impacted seasonal categories.

We are particularly pleased to see improved demand in seasonal categories over the past few weeks as the spring weather has finally arrived. In the quarter, 10 of 15 categories were above company average while 8 categories were up over 20% on a 2-year basis. Within our home decor division, paint and flooring delivered the strongest comps this quarter. Inside our paint category, the biggest growth drivers were in interior and exterior paint and primers as our in-stocks continue to improve throughout the quarter.

Also, our investments in our Pro Paint offering continue to pay off as we've enhanced our Pro service model, expanded associate training and have built out our job site delivery capabilities. We are building on this momentum with the recent launch of our new, incremental paint reward program for our MVPs Pro customers, in addition to the other meaningful rewards they have already received.

Within flooring, luxury vinyl was once again the top contributor as our consumers continue to prefer the low maintenance and stylish solutions that this product category has to offer. We also refreshed our STAINMASTER carpet lineup, continuing to reflect current styles and consumer preferences. And in late March, we launched our first extension of the STAINMASTER brand in tile. And right behind tile, we are launching new laminate and luxury vinyl products in STAINMASTER as well. We're excited to have the STAINMASTER brand within our portfolio and to extend its

high-performance characteristics and stain-resistant warranty to these new product categories. With this new brand lineup, we are offering innovative and functional products for the home, all with a great value for our customers.

Now turning to building products. We continue to see broad-based strength across key Pro categories, including electrical, building materials, rough plumbing, millwork and lumber, driven by strong Pro demand and competitive in-stock positions. Building on last year's strong performance, we delivered a positive 38% 2-year comp in building products, which continues to reflect the persistent underlying strength in consumer demand for larger core home improvement projects and, to a lesser extent, commodity inflation.

Over the past several years, we have been focused on expanding our brand and product offerings to meet the needs of our Pro customers. In this quarter, we are excited about the introduction of Owens Corning new fiberglass rebar known as Pink bar. This Pro family product is stronger than traditional steel rebar and 7x lighter which makes it both easier for the Pro to work with and less costly to ship.

We are also excited to announce the national expansion of the APOC roof coating brand, which is a leading manufacturer in roofing and an important strategic partner to Lowe's. These new products and brands are strong additions to our outstanding Pro brand portfolio, which already includes other powerful brands like Bosch, Crescent, DEWALT, Eaton, Estwing, FastenMaster, FLEX, GRK, ITW, LESCO, Little Giant, Lufkin, Mansfield, Marshalltown, Metabo, SharkBite, Simpson Strong-Tie, SPAX, Spyder and Werner.

Now looking at our performance in hardlines. As I mentioned earlier, our seasonal categories were impacted by delayed spring. As the weather has finally broken over the past few weeks, we have now seen higher demand across the seasonal categories. And it's important to remember that spring is always a first half event. And while this year's spring season has started slow, the teams are focused on delivering a successful spring again this year.

From the convenience and quality of the EGO, Kobalt, CRAFTSMAN and Skill brands with their zero-emission rechargeable equipment to our other leading brands such as John Deere, Honda, Husqvarna, Aaron's and CRAFTSMAN, we offer the products that our customers need to have the best-looking yard in the neighborhood. We are also continuing to expand our private brand lineup with new products in Origin 21, our new modern brand as well as our popular allen + roth brand, which is tailored to the more traditional taste.

SpringFest, which is our new approach to spring, is a multiweek event, and we leveraged several strategic promotions for popular spring items like mulch, soils and hanging baskets to deliver great value for our customers. And we are well positioned to capitalize on the late surge in spring demand, and I look forward to updating on this first half event on our second quarter call.

Now looking at Lowes.com. As Marvin mentioned, we saw a positive 2% sales growth in the quarter and over 39% positive growth on a 2-year basis. We continue to enhance the user experience on Lowes.com and our omnichannel capabilities, which is critical for consumers who increasingly expect flexibility and seamlessness in their shopping experience. Our new paint and countertop visualizers are driving better conversion rates and we also enabled our customers the ability to order bagged goods online for in-store pickup ahead of the spring season.

And as Marvin mentioned, our enhanced supply chain capabilities, including our expanded coastal holding facility network are now in place to enable us to flow product quickly to where it's needed as weather breaks across the country. And we continue to leverage our scale and carrier relationships to secure capacity and work to mitigate cost increases within our supply chain.

Before I close, I'd like to once again thank our vendor partners and our merchants for their hard work and dedication. Thank you, and I'll now turn the call over to Joe.

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

Thanks, Bill, and good morning, everyone. I would like to begin by thanking our frontline associates for their continued commitment to serving our customers, especially in this busy spring season. We are laser-focused on delivering a consistent and high-quality customer experience. At the same time, we have labor aligned to demand patterns so that we effectively managed our payroll this quarter even in a lower sales environment.

The investments that we've made over the past several years and our enhanced labor management tools are clearly paying dividends as we flex labor across stores and departments so effectively that we continue to achieve strong customer satisfaction scores.

Also, the technology enhancements that we've made over the past several years enable our associates to spend 60% of their time serving customers and only 40% on manual tasking activities. As a reminder, as recently as 2018, 60% of all associated time was allocated on tasks that did not support the customer. We flipped this ratio by enabling more and more capabilities on our associates handheld mobile devices, which eliminated many time-consuming tasks. This is in addition to new technology that has enhanced our point-of-sale checkout, modernized project management, improved inventory visibility and digitized in-store pricing for appliances and lumber. This improved associate productivity has not only driven profitability, but it has also enhanced our customer service.

And we continue to unlock further productivity through our Perpetual Productivity Improvement or PPI initiatives. As a reminder, our PPI initiatives are not onetime efforts but rather a series of initiatives that are scaling across our stores over time, all of which contribute to operational efficiency as well as a culture of continuous improvement. As Marvin mentioned earlier, the success of our PPI initiatives contributed to our strong operating margin performance in Q1.

Now I would like to take a few minutes to discuss our strong Pro results in the first quarter when we launched our MVPs Pro Rewards and Partnership Program, which is centered around creating a business partnership with our Pro. We are really pleased to see the better-than-expected adoption rates for the new program and we expect to build on this momentum with the Pros as we launch enhanced features to the loyalty program in the coming months.

Through this program, we are also gaining valuable insight about our Pro customers that will enable us to better anticipate and meet their project needs through our Pro CRM platform and allow us to continue to expand our share of wallet with these valuable customers. And we're expanding our Pro fulfillment capabilities with our new Pro fulfillment center in Charlotte, where we are stocking the top SKUs that Pros consistently need in job lot quantities. As we pilot this new approach to Pro fulfillment, we are building on our existing job site delivery capabilities handled through our stores and Lowe's Pro supply branches today. Although we are pleased with our 600 basis points of growth in Pro penetration over the past 3 years, improving our fulfillment capabilities will allow us to accelerate this growth and continue to gain market share.

In addition to the success of our new Pro initiatives, I am pleased with our strides to become the employer of choice in retail. As a company, we are committed to investing in continuous learning and development throughout our associates careers through Lowe's University as well as a new debt-free education program that we just announced. Through this initiative, more than 300,000 associates are eligible to participate in over 50 academic programs free of charge. These programs are designed to help associates excel in their jobs today and built toward their future careers within Lowe's, including pathways into supply chain, logistics, data analytics, cybersecurity, technology and more.

Finally, I'm pleased to report that we are in a better position from a hiring and staffing standpoint than we were at this time last year. We accelerated our associate hiring process through new technology that dramatically reduce the time it takes process applications. These new tools ensure that we capture the best candidates in the pipeline and helped us staff up quickly for spring. Looking forward, we are making the right investments to continue to drive productivity while also enhancing our customer service, and we are well positioned to serve our customers to meet the surge in demand for spring products.

As I close, I would like to once again thank our store associates for their relentless focus on serving customers and driving productivities in our stores.

With that, I will now turn it over to Brandon.

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

Thank you, Joe. I'd like to begin by saying what an honor it is to serve as Lowe's CFO. Over the past several years, we've made tremendous progress transforming Lowe's into a leading omnichannel retailer with a world-class finance organization. I'm extremely excited to be joining the executive leadership team in my new capacity as we continue our momentum.

Now turning to Q1 results. We delivered diluted earnings per share of \$3.51, an increase of 9% compared to prior year driven by improved gross margin rate and disciplined expense management against lower sales. As expected, we lapped our most difficult sales comparison of the year, given the approximately 300-basis-point benefit from government stimulus last year.

Q1 sales were \$23.7 billion with a comparable sales decrease of 4%. Comparable average ticket grew 9.1%, driven by higher Pro sales, increased levels of product inflation and 150 basis points of commodity inflation. This was offset by comp transaction count declining 13.1% due to a later start to spring as well as the impact of cycling over government stimulus and storm recovery in the prior year. Keep in mind that comp transactions increased 11.8% last year, which results in a 2-year comp transaction count decrease of 2.9%.

U.S. comp sales were down 3.8% in the quarter and up 19.7% on a 2-year basis. Our Pro sales outpaced DIY with 20% sales growth in the quarter as we continue to build on our momentum with the Pro driven by our elevated product and service offering. And while demand for core DIY categories remain strong, lower sales in seasonal categories pressured sales by approximately \$350 million in the quarter or approximately 150 basis points. On Lowes.com, sales increased 2% in the quarter and over 39% on a 2-year basis.

Our U.S. monthly comps were up 8.5% in February, down 7.8% in March and down 6.9% in April. In March, we cycled over the third round of government stimulus and the storm recovery sales in Texas while April sales were negatively impacted by unfavorable weather. Looking at U.S. comp growth on a 2-year basis from 2020 to 2022, February sales increased 34.5%, March increased 25.3% and April increased 6%.

Gross margin was 34.03% of sales in the first quarter, up 74 basis points from last year. Product margin rate improved 50 basis points as we leveraged our disciplined pricing and product cost management strategies to effectively manage product cost inflation and lumber price volatility. Also, higher credit revenue drove 25 basis points of benefit to gross margin this quarter, while a favorable product mix drove 20 basis points of benefit. These benefits were partly offset by 10 basis points of pressure from live goods damaged by unseasonably cold weather as well as 10 basis points of planned pressure from increased distribution costs.

SG&A of 18.19% levered 21 basis points compared to SG&A in Q1 last year. As Joe mentioned, we drove improved store labor productivity which was offset by lower fixed cost leverage against lower sales and increased wage rate. Operating profit was \$3.3 billion, in line with prior year. Operating margin rate of 13.96% of sales levered 67 basis points versus prior year. Our ability to leverage operating margin despite a decline in sales reflects our improved operating capabilities that enable us to rapidly adjust in a dynamic operating environment.

The effective tax rate was 23.7%, in line with prior year. Inventory ended the quarter at \$20.2 billion, up \$2.6 billion from Q4 levels in line with seasonal trends. This reflects a \$1.9 billion or 10% increase from Q1 2021. Our inventory balance reflects an approximately 13% increase from both product and commodity inflation, while balances were also higher than expected due to a late breaking spring.

Now turning to our 2022 financial outlook. Our Q1 performance was in line with our expectations, excluding seasonal categories. However, as Bill mentioned, spring is truly a first half event and the timing is driven by when weather breaks across the country. Over the past 2-plus weeks, we are seeing improved trends in our seasonal categories, which is reinforcing our confidence that we will deliver first half results in line with our full year guide.

This morning, we reaffirmed our full year 2022 financial outlook. We continue to expect 2022 sales in a range of \$97 billion to \$99 billion for the year, representing comparable sales of down 1% to up 1%. We continue to expect Pro to outpace DIY for the year. As a reminder, our 2022 sales outlook includes a 53rd week, which equates to approximately \$1 billion to \$1.5 billion in sales. We continue to expect gross margin rate for the full year to be up slightly as compared to prior year. However, as lumber prices declined several weeks earlier than we expected, gross margin pressure will shift into Q2 as we continue to turn through our higher cost inventory layers. As a result, we now expect to see our gross margin for the first half to be up slightly compared with our gross margin in the first half of 2021.

We also continue to expect operating margin in the range of 12.8% to 13% for the full year, driven by a slightly higher gross margin rate and continued execution of our PPI initiatives. We are also confirming our outlook for diluted earnings per share in a range of \$13.10 to \$13.60. In 2022, we still expect capital expenditures of approximately \$2 billion, and we remain committed to our disciplined capital allocation strategy with

approximately \$12 billion in share repurchases this year while also supporting our 35% target dividend payout ratio. Finally, we are affirming our outlook of return on invested capital above 36% for the year.

Now I'd like to close by reviewing one of our value creation drivers at Lowe's, our shareholder-focused capital allocation strategy. In Q1, the company generated \$2.6 billion in free cash flow. And through a combination of both dividends and share repurchases, we returned \$4.7 billion to our shareholders. During the quarter, we repurchased 19.2 million shares for \$4.1 billion, and we paid \$537 million in dividends at \$0.80 per share. Capital expenditures totaled \$343 million in the quarter, as we continue to invest in the business to drive growth and enhance returns.

We ended the quarter with \$3.4 billion of cash and cash equivalents, which includes proceeds from our \$5 billion notes offering in March. This larger-than-planned bond issuance enabled us to slightly accelerate our share repurchase plans in the quarter. The balance sheet remains extremely healthy, and we continue to make progress towards our target of 2.75x adjusted debt-to-EBITDAR, ending the quarter at 2.24x. Driven by both strong operating performance and a disciplined capital allocation strategy, we delivered return on invested capital of 33.8% in the quarter, up 380 basis points versus last year.

In closing, we are confident in our trajectory and excited for the substantial opportunity ahead of us as we continue to grow our market share, expand operating margin and deliver meaningful shareholder value. And with that, we are now ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today is coming from Greg Melich from Evercore.

Gregory Scott Melich - Evercore ISI Institutional Equities, Research Division - Senior MD

I have 2 questions. One is just to understand the shift of spring and stimulus. Should we be looking at a 3-year comp when we think about how that flows in, in the second quarter, sort of in the mid-30s? And then my second question is on inventory.

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

Greg, this is Brandon. Just as I mentioned in my prepared remarks, we came out of April, U.S. comps down 7% for the month. And I'll say early on, we feel really good about our trends in May, especially within our seasonal categories comping positive and above the company average as spring is breaking across the country. We have some of our biggest volume weeks ahead with Memorial Day, Father's Day, J4. We're pleased with the sequential sales improvement, confident in the full Q2 recovery of the \$350 million. And then when we look at the balance of the year, I think with the weather trends, Q2, \$350 million. We're going to continue to see the Pro strength 20% comp in Q1, [64%] 2 year. Inflation is going to continue to be a bit of a tailwind for us as well. But all that being said, our range is down 1 to plus 1. We're confident in that go-forward for the full year. And that yields Q2 to Q4. That's a slight positive comp over the balance of the year for the 1 year.

Gregory Scott Melich - Evercore ISI Institutional Equities, Research Division - Senior MD

Perfect. And then on inventory, you mentioned the 10% growth that inflation was -- and mix was about 13% of that. Am I -- does that imply that units are actually down 3% year-on-year.

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

Yes, Greg, Spot on. Inventory balance was up 10%, and we have in the prepared remarks price and commodity inflation, along with carrying additional seasonal inventory in Q2 -- heading into Q2 is pressuring both dollars and terms. I will remind the group every year, we do manage our seasonal inventory to the first half and we have a strong holiday lineup upcoming and a couple of other things. We continue to strategically invest in inventory to support the Pro, job locked quantities and we've had a couple of constrained categories where we've made in-stock improvements, in particular, in paint and appliances. But we're in our best in-stock position since the beginning of the pandemic, and I'll kick it over to Bill, if there's anything more he wants to add there.

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

No, I think, Brandon, I think you hit it. I think the key for us is making sure that we're focused on sell-through the seasonal buys that we've made. We shared with you during the fourth quarter call that we brought in some of the seasonal inventory ahead of the season. And so we're focused on working through that through the first half of the year.

Gregory Scott Melich - *Evercore ISI Institutional Equities, Research Division - Senior MD*

And you guys haven't seen any trade down, it sounds like?

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

Greg, this is Marvin. The answer is no. As you can imagine, we spent quite a bit of time looking at this literally on a daily, weekly basis with the DIY and Pro customer across geographies, online, and we've seen no material trade down in our business.

Operator

Our next question is coming from Brian Nagel from Oppenheimer.

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

First off, Brandon, congratulations on your new role.

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

Thank you, Brian.

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

My question, and I get -- maybe I'll direct it to Marvin primarily, but thanks for all the detail on the call. And I guess what I'll say is there, as analysts following where the news of weather disruptions are now well documented. As you look at the business, what gives you the greatest confidence that these slower spring sales were, in fact, weather-related and not indicative of a now say be more cautious consumer pulling back on discretionary spending?

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

Brian, this -- it's a really good question. This is Marvin. So I'll take the first part, and I'll let Bill just give more of a product-specific assessment. So when you take a look at the quarter, the month of February was really strong, 8.5% of positive comp in the U.S. In the month of March, we were running to a stimulus overlap and so we were anticipating that negative comping March was, and we had really difficult weather on top of stimulus. And then April, as we mentioned, was the coldest in over 20 years. And when we start to look at the categories and their anticipated performance, it was obvious to us that this was a weather-driven event.

The good news is, well, I mean, we operate in all states. So we could easily look at the southern parts of the country where we were in something relatively close to seasonal weather and all of these categories were performing exceptionally well, live goods, outdoor power, grilled patio, et cetera. And then the moment we get a glimpse of weather in some of these northern markets, those categories would take off and perform well in the moment, the weather would shift. I mean, obviously, you'd see the decline.

So the way we analyze this literally on a daily, weekly basis is very obvious to us that the Q1 impact was driven by weather. And as Brandon and I both mentioned in our prepared comments, as we look at the month of May, I mean we're pleased with the trends we're seeing. And that also reflects that the moment we are getting to what is more of a seasonal weather environment, those same categories that underperformed in April, are now overperforming the company in the month of May. So I'll let Bill add any other details.

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

No, I think the only thing to add, Marvin, is that we're also seeing strength out of new and innovative product. And so you look at the strength of like the EGO brand and the battery-powered outdoor product just continuing to perform very well. The strength of John Deere, the strength of Aaron's in the riding mower segments doing very well. And as you touched on, as we saw green shoots of weather throughout the first quarter, we saw the strength in project -- outside project businesses like live nursery, like exterior Pro projects. So it just gives us good confidence that we can carry that through Q2.

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

Brian, I'll just add one additional comment there. If you look at our Pro growth that Marvin mentioned earlier at 20%, and then you look at the strength and the health of that Pro -- strong Pro market trends we're seeing, our revamped Lowe's Pro offering, the expanded Pro product that Bill mentioned earlier in his prepared remarks, the deeper inventory and then the launch of our new MVP program. And so I think we've got good confidence in the underlying trends there.

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

That's all very helpful. I appreciate it. And I guess just one really quick follow-up. So as we think about these seasonal sales and the weakness that happened in Q1, is it fair to assume that basically, all the sales should be made up here in Q2? In other words, there's really no lost demand?

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

Brian, that's correct. It's fair to assume that the \$350 million would shift in fall of Q2.

Operator

Your next question is coming from Simeon Gutman from Morgan Stanley.

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

So the first quarter earnings, at least beat the Street handily and you're not making any change to the year. I think the second quarter, it sounds like you'll make up some sales. And so the first half will be the same. The fact that first quarter was better, did it -- and by the way, no one is getting paid or rewarded for raising any outlook. So I guess, implicitly, it means that something was taken out. I don't know if that's the right way to think of it or just there's conservatism. So curious your thoughts around that? And anything that is changing in the second half, the way you're looking at the business since you have some head start here in the first quarter.

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

Yes. So Simeon, this is Brandon. A lot of this is timing-related and specifically around gross margin. So as I said in my prepared results remarks for Q1, 74 basis points of improvement driven by product margin rate mix. We also benefited from proprietary credit. But keep in mind, the benefits on the product margin side are temporary in nature, especially -- can be temporary in nature, especially in periods of inflation. Cost layers are going to lag and that's true for both commodity and product-related inflation.

So as we cycle into Q2, we do expect some level of step back, specifically due to lumber deflation that began. We began seeing that late March. And then we have some other variables, such as shrink in credit. We expect that to largely be neutral over the back half. And then the supply chain, inclusive of market delivery build-out, higher transportation costs are going to be a slight drag, which is consistent with what we've guided and what we've messaged. So it's mainly margin, it's mainly timing as the cost layers turn a bit of a step back. But for overall margin, modest improvement in margins for first half and up slightly for the full year. So that's the reason we didn't flow the beat to the full year.

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

So Simeon, this is Marvin. I think it's important for me to note that we're really pleased with the profit performance in the first half. For a retailer our size is really difficult to have declining sales on a year-over-year basis and have leverage from an operating margin and gross margin perspective. That took a lot of work and a lot of operational discipline from the supply chain, cost management, payroll and expense management, et cetera. And to Brandon's point, we're in this unprecedented environment of lumber inflation and deflation. And so we're just planning conservatively because as we say, the last couple of weeks, we start to see lumber starting to shift, and we're just anticipating that, that's going to give us some headwind in Q2.

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

That's helpful. My follow-up, it's related on fuel prices. And Brandon, you just touched on transportation costs. Does this mean that you're adjusting your pricing as well real time? I know you mentioned you'll feel a little pressure, so maybe you don't fully offset it. And does the level of inflation help your business on the top line? Or you assume that there might be some unit degradation as pricing may continue to tick higher?

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

So let me take -- this is Marvin. I'll take the first part of that. We've spent a lot of time putting in improved systems from a pricing standpoint. So we are scraping and we're doing pricing analysis real time, both in-store and online by geography. One thing that Bill put in place early on when he arrived is that every day competitive pricing strategy where we've gotten off this high-low promotional cadence that Lowe's was known for to more of an everyday competitive price. And the only way you can be competitive every day is you have to have a good line of sight to the competitive prices of your competition by category, by geographic location.

And so we've done a lot of that. And in some cases, with inflation -- product inflation, we have to carry that forward to the consumer. But in a lot of cases, we're just focused on being competitively priced. And I'll let Brandon provide some financial specifics of what that looks like.

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

Yes, Simeon, I would just add to your question on fuel costs, transportation, also add import container cost into that mix. The teams have done a great job just giving us visibility to where those costs are, when they're going to hit. And it is correct to say as we manage the totality of the portfolio that, that's a consideration set along with direct costs from the vendor. So we are managing that appropriately, managing in this retail environment. So that would be the only additional thing I would add to the comment.

On transportation, in particular, on fuel, it is a more minor cost of the overall portfolio. When we look at the totality of supply chain, and we feel like we're doing some other things like managing trailers, intermodal and leaning into some of those other things to also help offset that.

Operator

Next question today is coming from Karen Short from Barclays.

Karen Fiona Short - *Barclays Bank PLC, Research Division - Research Analyst*

So I had a couple of questions. Just in terms of how you think about traffic versus ticket with respect to your guide, can you maybe talk about that a little bit more? And then within your margin structure, I mean, I do think there's definitional differences with you and your largest competitor on how you actually think about square footage. But can you maybe just give us an update on -- in terms of your 13% operating margin or and/or bridging the gap with your largest competitor?

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

Yes. Karen, let me start with the first question, and I'll pass it back to Marvin to get the second point. So on the ticket transaction side, I'll point to Q1 ticket, specifically inflation, a little bit harder to pinpoint. But we do believe from an inflation standpoint, we ran high single digits during Q1, and that's inclusive of 150 basis points from lumber and commodity. And I'll say the finance and merchant teams are still in the thick of this. We're working with our suppliers day in, day out to figure this out.

I will say, however, as we lap second half of '21, we do expect the inflation impact to start to moderate. We're expecting mid to high single-digits positive over the balance of the year. And then on the transaction side, as we mentioned in the opening comments, DIY was a primary driver of the decrease there for Q1. It was down double digits, partly planned due to the Texas storms and the stimulus, the weather miss from spring delayed accelerated that. We do believe Q1 will be our low watermark on transactions for 2022 and that, that transaction decrease should moderate as we cycle through the balance of the year.

So net-net, mid to high single-digit positive ticket expected over the balance of the year, offset by down transactions is the formula that will get us to the flat comp, and we expect that dynamic to narrow ticket and transactions as we move through the balance of the year.

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

Karen, I'll take the other question. When you think about our operating margin and you think about kind of the more structural differences between us and our largest competitor, I think it really comes down to the penetration of DIY versus Pro. I think that's an obvious reflection in the first quarter. The good news for us is, we're not setting a Pro penetration target. We just have an expectation we're going to continue to improve that business. And if you think about my prepared comments, in the last 3 years, we've been increasing our Pro penetration by roughly 600 basis points. So we feel like that we're headed in the right direction.

But as you think about overall operating income, we're very pleased with our performance in the quarter, and we have a very good line of sight to getting us to that 13% and beyond just based on executing our Total Home strategy, focusing on Pro, online and all the work that Bill's team is doing on private brands and how we're continuing to grow that business. In the private brands specific initiative, it drives margin improvement.

It gives the customer great innovation and style and we can do it all at a really competitive price and it's a key point of differentiation in addition to all the investments we're making in infrastructure, whether that's supply chain or operations and infrastructure. Again, we feel like we have a clear line of sight, and we're going to continue to execute to that, and we have an expectation that we're going to be on track with delivering on that expectation.

Operator

Your next question today is coming from Christopher Horvers from JPMorgan.

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

So my first question is just following up on the May commentary. You talked about DIY now running ahead of the total company average comp. If you're still getting 20% growth in Pro backing into that math, that will sort of cleanly get you above the mid-single-digit comp. Is that math reasonable?

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

Yes, Chris, this is Brandon. I don't know that we said that DIY is going to be running ahead of Pro in Q2. I would say the majority of the \$350 million that we expect to recover is going to be reflected in the DIY business. But the Pro DIY dynamic, certainly unique in Q1, just given the environment we've been in and what we've been cycling, but that breakout in that dynamic, Q2 to Q4 should start to normalize a bit. But Pro is absolutely going to be expected to outpace DIY, grow 2x that of market, which will translate to our guide of down 1% to up 1%. And I'll just remind you, the seasonal performance in the seasonal business through the first couple of weeks outperforming expectations in the balance of the business. So that's how I would answer your question.

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

Okay. Sorry, I thought you said outperforming the company average. It was outperforming expectations.

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

Correct. Correct.

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

Got it. All right. Sorry about that. And then in terms of -- Marvin, in the press release, it seems like you added just a line around sort of increased macro uncertainty. To an earlier question, you mentioned not seeing any trade down effect in a very responsive business to the weather. So can you expand on that? Is there something you are observing? Is it just simply given all the puts and takes on the consumer being less fulsome now versus maybe 3 months ago?

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

It's really more of an acknowledgment of what we're all seeing in just a broader macro economy. And I think what's interesting for home improvement is that, we're aware that we have inflation concerns. We're aware that there is rising interest rates. But as we look at the home improvement sector, we still remain very confident in the outlook and we're very confident in the sector. And so I'll just repeat what I've said. We've seen no material trade down from our customers. We closely monitor Pro and DIY. We look at it intently as you can imagine.

And when we think about the key economic drivers of our business, it remains home price appreciation. It remains the age of housing stock, it remains those things that give the homeowner confidence and continuing to invest in the home. And as we talk to our Pro customers, they're booked up for the year. We talked to our DIY customers, they would just wait for the sun to come out. And so we feel good about the home improvement sector. And my statement was just more of an acknowledgment of the broader macro environment that we're all seeing.

Operator

Your next question today is coming from Liz Suzuki from Bank of America.

Elizabeth Lane Suzuki - *BofA Securities, Research Division - VP*

So we've written recently about how 95% of the base of U.S. homeowners are not impacted by interest rates and that housing turnover isn't really as important as home price appreciation. But the pushback we've gotten is that those 5% of homes that do change hands presumably see a greater degree of renovation spending. So my question is, have you seen any reliable stats on how much the average homeowner spends on renovation when they prepare a home for sale and when they purchase a home? Because we're just trying to get a sense of what that portion of the home improvement market is actually impacted by rising rates.

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

Liz, it would be anecdotal at best. So we don't have any firm data to represent that. But our view of it and our conversations with Pros and consumers, you tell us that your statement is correct. But again, we don't have any fact-based data to support that.

Elizabeth Lane Suzuki - *BofA Securities, Research Division - VP*

And then just a quick follow-up on how product innovation has contributed to average ticket. I mean, the growth in average ticket is obviously more than just inflation. So what do you view as the categories where product innovation may be accelerating the normal replacement cycle and how much of a tailwind that could be when inflation does ultimately normalize?

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

Yes, Liz, it's Bill. And so what we're seeing with product innovation, we really see it across the store, across every category. But in areas like appliances, you see customers trading up to smart appliances to better quality appliances. As I mentioned in an earlier question in response, battery outdoor power equipment with the EGO brand specifically. You're also seeing it in the likes of gas-powered outdoor power with John Deere and Aaron's, all innovative products there. You're seeing it in paint. So just really across the categories, you see innovation.

And we're also able to offer that in our private brands with the introductions of STAINMASTER. So you're seeing that now start to weave its way in. I talked about -- it's already been in carpet and now you're seeing in tile, vinyl, laminate flooring. So you got Origin 21, which is a new modern brand for us, again, offers great innovation and great value.

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

And Liz, this is Marvin again. I just want to reinforce the point on the value of home price appreciation to consumer confidence. And it's one of the reasons why I think home improvement is a unique retail sector in kind of this macro environment where there are a lot of questions about the health of the consumer. What our data tells us and it correlates historically is when your home value is going up, you simply have more confidence to invest in that home because you see it as an investment and not an expense.

And we have unprecedented home price appreciation, but we also have an unprecedented supply-demand issue for the availability of homes. So our data tells us, this is less of bubble and it's more of a supply-demand issue where you have 1.5 million, 2 million homes of demand versus the availability. And so if you think about what Bill said about trading up, our customers, they feel more comfortable investing in home because they think they're going to get a return on that investment. And I think that's the value of home price appreciation to our business.

Operator

Our next question today is coming from Zach Fadem from Wells Fargo.

Zachary Robert Fadem - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Can you help me reconcile the sequential step-down in SG&A dollars? How much would you quantify as seasonal versus what would you call structural or PPI-driven? And then how should we square the Q1 SG&A takeout versus the balance of the year?

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

So Zach, this is Marvin. I'll take the first part of that, and then I'm going to let Brandon and Joe provide some context. So relative to payroll, we have an activity-based payroll model that allows us to flex hours up and down based on sales velocity by location of store, but also by department. That is a significant contrast to what we had in place when I arrived in summer of 2018 that we literally were riding complete the schedule from Mooresville, North Carolina and sending that out to every store on a weekly basis, irrespective of volume trends. So I'll let Joe talk about payroll, so you can get a view of why we were able to leverage as effectively as we did in Q1 and how we think that's a sustainable result that we'll see for the balance of the year.

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

Yes. Thanks, Marvin. Listen, from a payroll standpoint, I think it's important to think about the PPI initiatives as not just onetime initiatives, but ongoing initiatives. And so as we look at our ability to leverage SG&A through different initiatives, centralized RTVs and get down a whole list of the PPI initiatives. So this is not a onetime, but it's going to continue. And I think we've done it very effectively because both Pro and the do-it-yourself customer are showing increased LTR and service scores. So I think that just kind of points to some good productivity.

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

Yes. And the only other thing I would add, Zach, so SG&A leveraged 21 basis points. That's consistent with the earnings algorithm we have for the full year in the range of what we would expect. I think the good news there being able to leverage against our quarter with the highest expected negative comp is going to be a great proof point for us and as we move through the year. And then in this inflationary environment, I think, to Joe's point, really being able to use those workforce optimization tools, understand truly within the business, both in the supply chain and in stores, what are volumes, what are units, what are transactions and being able to flex the model against that demand and understand the split between the drivers of the business has been really powerful for us. So I'll just add to that.

Zachary Robert Fadem - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Got it. And with the spread between your Pro and DIY comps widening to about 30 points in the quarter, I realize the weather and seasonal component will normalize. But as you think about the balance of the year, how do you square overall industry Pro industry growth versus DIY this year? And is it fair to assume your Pro business can track at a double-digit rate from here?

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

Well, Zach, we talked about our expectation to grow 2x the market in Pro. We think that, that is achievable based on the list of Pro-related products that Bill and his merchant teams have added to our assortment based on our new MVP Loyalty Program that's exceeding expectations on the number of enrollments. And one other really interesting data point, if we look at the Pro customers currently enrolled in our new MVP Loyalty Program and our credit program, they're spending 300% more than Pro customers not enrolled. So it gives us a lot of confidence that our Pro growth is sustainable.

And not to mention with some other initiatives that we are filing to include job site fulfillment that we think will give us an opportunity to start in the future to serve a larger Pro. So based on all of those initiatives, we feel like that our Pro growth will continue. Look, it's challenging, none of us have a crystal ball, obviously, and there are a lot of dynamics in our Pro DIY mix. Having said that, we factored all those things into our guidance, and we think that the guidance, as Brandon reinforced is reflected on our view of how we think the DIY Pro mix will play out for the rest of the year.

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

Thank you all for joining us today. We look forward to speaking with you on our second quarter earnings call in August.

Operator

Thank you. That does conclude today's teleconference and webcast. You may disconnect your line at this time, and have a wonderful day. We thank you for your participation today.

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