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LOW.N - Q1 2023 Lowe's Companies Inc Earnings Call

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OVERVIEW:

LOW reported 1Q23 sales of $22.3b, GAAP diluted EPS of $3.77 and adjusted diluted EPS of $3.67. Co. expects 2023 sales to be $87-89b and adjusted EPS to be $13.20-13.60.

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PRESENTATION

Operator

Good morning, everyone, and welcome to Lowe's Companies First Quarter 2023 Earnings Conference Call. My name is Rob, and I'll be your operator for today's call. As a reminder, this conference is being recorded. I'll now turn the call over to Kate Pearlman, Vice President of Investor Relations and Treasurer.

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

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

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

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

Now I'll turn the call over to Marvin.

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

Thank you, Kate, and good morning, everyone. In the first quarter, our comparable sales declined 4.3%, driven by approximately 350 basis points of lumber deflation, unfavorable weather and lower DIY discretionary sales. We continue to build momentum with the Pro through our MVPs Pro Rewards program and our expanded assortment of Pro national brands. Lumber deflation disproportionately impacted Pro sales by approximately 800 basis points of comp pressure and despite this pressure, comparable Pro sales were slightly positive in Q1 with broad-based strength across multiple categories. This positive comp in Pro builds on top of a 22% U.S. Pro comp in the first quarter of last year.

DIY sales were pressured by delayed spring and lower-than-expected discretionary demand, although we are encouraged to see better trends in periods of favorable weather. A late start to spring disproportionately impacts do-it-yourself customers who represent 75% of our business, given many seasonal categories are heavily concentrated in DIY. As weather improves, we're optimistic that customers will re-engage with spring projects, and we are ready to support the increased demand with our best in-stock position and staffing levels in 3 years, coupled with improved omnichannel and fulfillment capabilities. However, we are expecting a pullback in discretionary consumer spending over the near term. Given these trends, we're updating our full year outlook this morning.

Despite market pressures, we are pleased to see market share gains this quarter, and we expect to continue to outpace the market as we execute against the growth initiatives of our Total Home strategy. We're also confident in our ability to drive continued productivity through our perpetual productivity improvement initiatives or PPI. This operational discipline and agility helped us to offset the impact of lower sales and higher wage costs in Q1.

Adjusted operating margin expanded 47 basis points in the first quarter, leading to adjusted diluted earnings per share of $3.67, a 5% increase compared to last year. While we can't control commodity deflation, weather or macroeconomic uncertainty, we can control how effectively we operate our business and adapt to a changing environment.

A key component of our transformation that is often overlooked is the culture of continuous improvement we've introduced at Lowe's, which is the foundation of our perpetual productivity improvement initiatives. And although our PPI initiatives originated in store operations, we're now focused on driving productivity across all areas of the company. And we see tremendous runway ahead for continued productivity across the business including dozens of PPI work streams in merchandising, store operations, supply chain and corporate support functions.

As an example, we're replacing our 30-year-old operating system with a modern omnichannel architecture that will enable a seamless, intuitive customer experience while removing complexity for associates. This project has been underway for 4 years, and we are pleased that we are on track to retire all legacy green screens by the end of this year. This new modern operating system will allow us to unlock a significant amount of labor productivity and deploy new capabilities including enabling more seamless omnichannel selling from within our stores.

In addition to our new operating system, our penetration of rural stores gives us an opportunity to drive sustainable profit growth due to the much lower expense base that's required to operate these stores. As an example, what we spend to operate our store in Philadelphia, Mississippi is significantly less than the cost to operate one of our stores in Philadelphia, Pennsylvania. While in years past, our penetration of rural and remote stores was viewed as a competitive disadvantage, we now expect that these stores will be a key component of our operating profit growth over the next 3 to 5 years. Given our confidence in this trajectory, we set long-term targets of $1.5 billion to $2 billion in incremental productivity gains at our December Analyst and Investor Conference and we are tracking our progress against those initiatives on a monthly, if not, a weekly basis.

In addition to our disciplined focus on productivity, this quarter, we also continued to make strides with our Total Home strategy. And in Pro, our growth was fueled by continued acceleration of our MVPs Pro Rewards Program and CRM tool, coupled with our improved Pro assortment, inventory depth and omnichannel capabilities. These initiatives have enabled us to continue to gain traction with our core Pro customer, which is a small to medium-sized Pro. Joe will discuss some of the exciting new Pro initiatives later in the call.

Our online sales also accelerated this quarter with 6% comparable sales growth, representing more than a 10% sales penetration. Online growth was supported by an increase in Pro sales as we continue to upgrade our Pro digital experience with new tools and personalization. We also continue to enhance our DIY online experience by making home improvement projects easier for consumers to visualize, estimate and shop. And these investments are paying off with higher online conversions and attachment rates.

In supply chain, we continue to roll out our market delivery model, bringing us to 12 geographic regions across the country, supporting more than 1,100 stores. And we're pleased that this more efficient model of delivering big and bulky products is already enabling us to accelerate our market share gains and appliances and will enable future growth in other big and bulky product categories. And we remain on schedule to have market delivery rolled out by the end of 2023.

And despite a macroeconomic environment with mixed signals creating near-term pressures, we remain optimistic about the future of home improvement. And once we navigate through this uncertainty, we remain bullish on the long-term outlook for our industry due to the unique convergence of structural drivers and demographic trends that are supportive of home improvement demand. And we feel fortunate to operate in such a favorable sector of retail, where 2/3 of our sales remain nondiscretionary. And as we navigate this near-term pressure, we will continue to monitor trends closely and we are confident that we have the agility needed to quickly adapt to any scenario.

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

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

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

Thanks, Marvin, and good morning, everyone. During the first quarter, 5 of our 14 merchandising categories were positive, building materials, rough plumbing, paint, hardware and appliances. We continue to see broad-based Pro strength across all 3 merchandising divisions. In home decor, paint and appliances delivered the strongest comps this quarter. Our momentum in appliances continues to build as we drove higher unit sales and work to continue to take market share by leveraging our improved omnichannel shopping experience, enhanced market delivery capabilities and expanded assortment.

Appliances are a great example of an omnichannel category, where customers often compare options online, then visit our showroom to see products in-person and then get their questions answered by one of our appliance specialists. And with our improved online capabilities like easy scheduling and order tracking, we continue to see more and more of our customers getting comfortable completing their purchases online. In the U.S., we estimate that roughly 100,000 appliances break every day. So our investments in fast appliance delivery and a seamless omnichannel shopping experience, positions us well as the go-to destination for these urgent and often nondiscretionary needs.

We are also seeing increased demand in paint, especially from our Pros who paint as they take advantage of our paint job site delivery, our MVPs Paint Rewards Program and our improved product assortment. This quarter, we took the next step in catering to these important customers by launching Spec Right interior paint in partnership with Sherwin-Williams. This is our first exclusive line of tintable paint formulated specifically for Pros.

Within decor, we recently launched new closet organization solutions across 4 private brands to meet a range of storage needs and budgets. This includes modular, easy-to-install wood or wire closet systems that are modern, customizable and a far better value than the competition. Our private brand strategy allows us to deliver value to DIY customers who are looking for high-quality, on-trend products at more affordable price points which enables us to provide differentiation, loyalty and profitability.

Turning to building products. Building materials and rough plumbing led the way. In building materials, we saw broad-based strength, reflecting the investments we made to improve our Pro offering through an enhanced assortment. You may remember, last year, when we announced a new 10-foot fiberglass rebar known as PINKBAR by Owens Corning. This product exceeded our sales expectation given its strength, lightweight materials and corrosion resistance. This year, we're building on that success with the new 20-foot PINKBAR product, designed to help Pros reinforce bigger structures using fewer connections, ultimately saving them time and money on material costs.

Rough plumbing was driven by strength in water heaters, HVAC, plumbing repair and pipe and fittings. As we continue to strengthen our offering for the Pro and the DIY consumer in these categories. And while lumber comps were pressured by steep year-over-year lumber deflation, the category had the highest unit comp in the company this quarter, reflecting strong Pro demand. We are pleased with our continued enhancements to our strong assortment of Pro products from trusted brands like Bosch, DEWALT, Eaton, Estwing, FastenMaster, FLEX, GRK, Hubbell, ITW, Klein Tools, LESCO, Little Giant, Lufkin, Mansfield, Marshal Town, Metabo, SharkBite, Simpson Strong-Tie, SPAX, Spyder and Werner.

In hardlines, our performance was pressured by the delayed spring, some volatile weather in the West and softer discretionary spending. However, we did see higher demand during periods where weather improved. In lawn and garden, we proactively partnered with our live goods vendors to increase our agility in responding to changing weather patterns, which was critical in a season marked by erratic weather. Our live good vendors play a key role each spring as we continue to refine our local offerings in addition to the timing of when product arrives to our stores.

This year, they help support our new Green Vest program, where our merchandising service team or MST associates, along with support from our vendors, now provides service to our garden centers, taking the tasks off the shoulders of our Red Vest associates to allow them to focus on serving the customer. We also continue to expand our private brand offering including a full lineup of new and innovative lawn fertilizers and grass seed products through our Sta-Green brand, which is already exceeding our expectations.

And in hardware, in addition to delivering a positive comp, we also saw strong attachment rates alongside the higher lumber unit sales and strength in building materials, powered by the improved assortments of the key fastening brands like SPAX, GRK, FastenMaster, ITW and Power Pro One. As we continue to enhance our assortments at a national level, we also continue to advance our localization work. This is a key pillar of our Total Home strategy with the goal of expanding market share, increasing inventory productivity and protecting our margins. We have been piloting a localized framework for a few common market categories like rural and urban stores. Today, I'm excited to announce we are now scaling our rural framework to as many as 300 additional stores by year-end, with a wider offering of farm, ranch and outdoor products that positions Lowe's as a one-stop shop to make it convenient for rural customers to get what they need in one shopping trip.

Our rural format includes broader product offerings in categories such as pet, livestock, trailers, fencing, utility vehicles, specialized hardware and our new Carhartt Apparel, all designed to meet the unique needs and preferences of rural homeowners who work and play outdoors. Given our rural store footprint, and long-standing relationships in these communities, we see this as a natural opportunity for our business and one that will simplify the shopping experience for these very valuable customers. And as Marvin mentioned, we see the productivity improvements in these stores as a key component to delivering sustainable growth in our operating profit.

We also remain focused on our many merchandising PPI initiatives, including leveraging our modernized cost optimization tools to negotiate costs with vendors and we're getting more strategic and surgical in our inventory planning to focus on more high-velocity core inventory items with low markdown risk like Pro replenishment and fewer slow velocity SKUs.

From a technology standpoint, in the first quarter, we completed the rollout of new dedicated Zebra smartphones for all MST associates ahead of schedule. These devices are equipped with the new MST app designed to optimize their time with technology that leapfrogs the competition. The system automatically prioritizes planogram changes, pricing updates, base service and other projects to optimize associates' time on the most efficient, highest value next task. And it also gives associates step-by-step instructions to maximize productivity and minimize the learning curve for new associates. This app was built internally to seamlessly integrate with our other mobile apps.

For example, each time an MST associate resets a bay, the product location automatically updates in our associate product app and our customer mobile app. So both associates and customers can quickly find what they're looking for. As I close, I'd like to again extend my appreciation to our vendors and our merchants for their partnership, hard work, innovation and continued support.

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

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

Thank you, Bill, and good morning, everyone. At Lowe's, we are committed to being the employer of choice in retail for associates to choose to build their careers. As a reflection of this commitment over the last 3 years, we have increased the hourly rate for our store associates by 20%. And since 2018, we have invested over $3 billion in incremental wage and share-based compensation for our frontline associates. As a result of our consistent and ongoing commitment to our hourly associates, we are seeing our best staffing levels in 3 years, improved retention and the highest customer satisfaction scores in our company's history.

In addition to compensation, we are also taking other steps to show appreciation to our associates, including simple initiatives like lowering the prices of the food in our store break rooms and closing our stores on Easter for the fourth consecutive year. These expressions of appreciation may not sound overly complex, but to our hourly associates, they matter. As a former hourly associate, one way I measure improved associate engagement is by tracking the number of people who transition their jobs into careers. More than 85% of leadership roles are now filled from within up nearly 700 basis points over the last 2 years.

Our frontline associates deserve all the credit for the transformation of our company, and I would like to personally thank all of our associates for everything they do to support each other, our customers and our communities.

Now let me transition to Pro, one of the highlights in the first quarter. I'm excited to announce that we've just launched new Pro online business tools, the latest enhancement to our MVPs Pro Rewards program, which is designed to make Pros of all sizes feel like MVPs at Lowe's. Through our surveys, we learned Pros would welcome time-saving tools that help them shop quickly and minimize time away from the job site. At the same time, we learned our Pro associates spend a lot of time building quotes and checking order status, tasked to take them away from serving customers in their stores.

To solve for both needs, we launched a suite of tools on Lowes.com and our mobile app that make it easy for Pros to manage their orders from anywhere, whether that's on-the-job site, at home or out of town. Rather than having to drive to our stores to get a quote, Pros can now build and update online quotes in minutes. It automatically applies to their volume savings pricing and discounts and lets them quickly download a PDF quote for their customers. They can also use order tracking to track the status of the order throughout the fulfillment process.

Pros tell us they love how easy and simple these tools are. In one Pro's words, he appreciates the convenience of being able to get a price, get it ordered and get it done. While these tools just launched in April, we are already seeing better-than-expected adoption rate and sales growth and expect results to accelerate as more Pros discover the new features. Our traction with Pros online is just one example of the momentum we are seeing in our MVPs Pro Rewards Program and one of the reasons we delivered a positive sales comp in Pro for Q1.

Pros enrolled in our loyalty program continue to shop more frequently and buy more per trip and spend more overall. As our CRM tool matures, we are using data insights to identify trends that can improve our marketing and sales strategy, including tailoring our offerings by trade and by tier. These improved Pro capabilities and offerings are reflected in our Pro customer satisfaction scores, which are up 200 basis points over last year. In our April survey, over 75% of Pros continue to say their backlogs are healthy. While the Pro backlogs remain consistent with recent quarters, Pros did report a shift to smaller project sizes.

Moving on to productivity. We continue to scale a series of perpetual productivity improvement initiatives or PPI. First, we remain laser-focused on technology modernization across all areas of our stores including rapidly replacing legacy self-checkout systems with our proprietary self-checkout registers. We are encouraged to see higher customer adoption, throughput, labor productivity and customer satisfaction on these registers and will complete all remaining stores later this year.

We've also matured our new store inventory management system, or SIMS, which continues to improve our inventory visibility and operational efficiency. It also fully integrates with the mobile apps Bill just mentioned, reducing the time both associates and customers spend searching for product. We also continue to enhance our pick up in store experience to streamline processes and enhance technology. These improvements drove faster fulfillment and a 400-basis point increase in pickup in store customer satisfaction scores in the first quarter.

As we approach Memorial Day, I'd like to thank any veterans listening in for their service. As a marine who served combat tours in the Gulf War and Desert Storm, I'm proud of Lowe's long-standing history of giving back to our military community including a 10% military discount. And we are proud to support these customers who have given so much to our country.

As I close, I would like to thank all our store leaders and associates once again for their hard work to serve customers, drive results and improve this business each and every day.

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

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

Thank you, Joe. Beginning with our Q1 results. We generated GAAP diluted earnings per share of $3.77 compared to $3.51 last year. Now my comments from this point forward will include certain non-GAAP comparisons where applicable. Non-GAAP measures have been adjusted to exclude the gain associated with the sale of our Canadian retail business.

In the quarter, we recognized a net pretax gain of $63 million on deferred consideration associated with the sale of our Canadian retail business. Excluding this benefit, we delivered adjusted diluted earnings per share of $3.67, an increase of 5% compared to prior year. Q1 sales were $22.3 billion, which includes approximately $735 million related to a shift in our fiscal calendar as we cycle over a 53-week year. Also, as a reminder, prior year sales included $1.2 billion generated in our Canadian retail business.

As Marvin mentioned, comparable sales were down 4.3%, partly driven by a later start to spring and a more cautious consumer. This also includes approximately 350 basis points of lumber deflation. Please note that comparable sales are calculated based on weeks 2 through 14 in fiscal 2022. Comparable average ticket was down 0.3%, largely driven by lumber deflation as ticket increased in the majority of our other merchandise divisions. Comp transactions declined 4% due to the delayed start of spring and lower-than-expected DIY discretionary sales. Our monthly comps were down 3% in February. With unfavorable weather patterns across the country in March and April, comps declined 5.4% and 3.9%, respectively.

Lower sales in seasonal categories pressured sales by approximately $400 million in the quarter, or approximately 175 basis points. Gross margin was 33.7% of sales in the first quarter, down 35 basis points from last year. Gross margin benefited from a favorable product mix, offset by costs associated with the expansion of our supply chain network. There was no meaningful impact from shrink or credit revenue in the quarter. Also keep in mind that product margin in the prior year quarter reflected a timing benefit driven by product cost inflation. Adjusted SG&A of 17.4% of sales levered 79 basis points. As Marvin mentioned, this performance reflects an enterprise-wide disciplined focus on PPI that helped offset pressure from lower sales and wage investments. It also includes the benefit of a onetime legal settlement.

Adjusted operating margin rate of 14.4% of sales levered 47 basis points. The adjusted effective tax rate was 23.6% in line with prior year. Inventory ended the quarter at $19.5 billion, down $0.7 billion compared to Q1 of last year. As a reminder, prior year inventory levels includes our Canadian retail business. U.S. inventory units finished the quarter slightly down to last year.

Now turning to our 2023 financial outlook. Given the higher-than-expected pullback we've seen in home improvement spending, we are now expecting our relevant market, which reflects our 75% DIY, 25% Pro mix to be down mid-single digits this year. But while we are seeing lower-than-expected DIY discretionary demand, we are also driving better-than-expected results in Pro and continued strength in our online sales and core categories like appliances and paint. This reinforces our confidence that we will continue to take market share and outperform the broader market.

We are now expecting 2023 sales of $87 million to $89 billion with comparable sales expected to range from down 2% to down 4%. Please note that the updated outlook also reflects the impact of lower-than-expected lumber prices. This creates an incremental 50 basis points of pressure on full year sales as compared to our original expectations. We continue to expect Pro to outpace DIY for the year as Pro backlogs are healthy, and demand for Pro services remain strong. We now expect adjusted operating margin in the range of 13.4% to 13.6% for the full year driven by PPI initiatives across the company, partly offset by planned wage investments and lower sales volumes. We expect capital expenditures of up to $2 billion this year and with our planned share repurchases, we expect to reach our 2.75x leverage target by the end of the year while maintaining our BBB+ credit rating.

Finally, we are also updating our outlook for adjusted earnings per share in a range of $13.20 to $13.60. Keep in mind that our outlook for operating margin and diluted earnings per share are now adjusted to exclude the gain associated with the sale of our Canadian retail business that we recorded in the first quarter.

To assist you with your modeling, I would like to spend a moment discussing our expectations for the second quarter. We are expecting an approximately $400 million headwind to sales due to the timing shift in our fiscal calendar. We also expect lumber deflation to pressure Q2 sales by approximately 150 basis points. Finally, we expect $250 million benefit to sales from the delayed spring. Taking all of this into account, we are expecting Q2 sales towards the higher end of our full year guide. We are also expecting adjusted operating margins slightly above prior year results, partly due to the impact of the shift in our fiscal calendar as well as the timing of several productivity initiatives that are already in flight.

Turning to our capital allocation strategy. During the quarter, the company generated $1.7 billion in free cash flow. We repurchased 10.6 million shares for $2.1 billion and paid $633 million in dividends at $1.05 per share, returning $2.8 billion to our shareholders. Capital expenditures totaled $380 million in the quarter as we continue to invest in our strategic growth initiatives. We ended Q1 with $3 billion of cash and cash equivalents which includes proceeds from our $3 billion notes offering in March. We ended Q1 at 2.62x adjusted debt to EBITDA. Finally, we delivered return on invested capital of 28%, inclusive of a 725-basis point impact related to transaction costs associated with the sale of our Canadian retail business and the discrete gain in Q1.

In closing, we are confident in our ability to execute our Total Home strategy while navigating near-term market uncertainty. And we remain committed to our best-in-class capital allocation strategy centered around delivering sustainable shareholder value.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from the line of Liz Suzuki with Bank of America.

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

So I think previously, we had heard a lot of focus on higher sales per square foot as the main driver of operating margin improvement. Now I think you guys are talking more about the benefits of operating in lower-cost markets like the more rural stores. So presumably, those stores have lower sales per square foot in your stores in more densely populated markets. So how are you thinking about geographic mix and potential for stores benching going forward if those more rural areas are now looking more attractive?

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

Liz, this is Marvin. I think it's more in tune with what Bill talked about with some of the investments we're making in those rural stores. As we survey those customers, they give us a list of things they wish they could purchase in one shopping occasion and some of those types of things like Carhartt Apparel, farm and ranch types of items and categories as part of our expansion opportunity. And we think by doing those types of initiatives, we're going to see sales per square foot actually improve.

As a matter of fact, when we look at the pilot stores where we've been very diligent on going after those specific categories, we actually saw that within the pilot locations. And so that is leading us into this roughly 300 store expansion of these extended categories. And we just see this as a unique opportunity. I mentioned that the expense base is lower. But as you said, if you can have a lower expense base, then you can improve sales per square footage, that in a combination of all the other initiatives we're doing around the company, we think will continue to drive our profit growth. And I'll let Brandon add any additional comments.

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

Liz, this is Brandon. Just as we think about the CapEx, as Marvin mentioned, we're not necessarily looking at opening stores over the long term is really part of our core strategy, but we love what we're seeing with these rural stores. We initially piloted on a smaller subset of locations. We love the profit profile of these stores within these rural markets, and we've been very thoughtful around the assortments and where we're rolling out and really excited to see this scale as we move through 2023 and what this can deliver from a top line perspective beyond that.

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

Great. And in those stores, just as a follow-up, are you seeing online penetration that's similar to your overall company average? Or is it a little bit lower? Is it higher? Just curious if there's any difference in the online mix?

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

Liz, it's about the same, but I mentioned in my prepared comments that we're retiring this old legacy operating system and by retiring this system, it opens up the ability to have really true omnichannel selling in the store. So we see omnichannel and e-commerce growth only accelerating with the ability of our 300-plus thousand associates having the ability to more easily transact in the store, thus connecting physical and digital in a more seamless way.

Operator

Our next question is from the line of Christopher Horvers with JPMorgan.

Mr. Hovers, perhaps you're muted.

Okay. I'm going to move on to our next question, which is coming from the line of Simeon Gutman with Morgan Stanley.

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

Can you hear me?

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

Yes, we can, Simeon.

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

My question is, first, I'm trying to sort out the guidance. If you take the Q2 through Q4, what's embedded, both for sales and margin, is that roughly the same as what it was, call it, when you guided a year? Or has anything changed.

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

Simeon, thanks for the question. This is Brandon. Let me just kind of speak a little bit to the curve specifically. When we look at Q2 as I mentioned in the prepared remarks, expecting Q2 sales towards the higher end of the full year guide. That's inclusive of the $250 million delayed spring benefit, offset by the 150 basis points lumber deflation and then the $400 million, week shift drag. As we start to transition and look at the second half, we do expect the Pro business is going to continue to outperform and drive our growth. We mentioned that backlogs remained healthy and we expect that business to continue to outpace DIY.

The lumber inflation is -- or deflation is going to moderate as we start to look at second half and we cycle over more normal pricing over the balance of the year and then continued strength in what we're seeing with the online business and in core DIY businesses like appliances and paint. So taking all that into account when we look at the second half, we're looking at that in line with the full year guide.

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

That's helpful. And then maybe a follow-up, sticking with the guidance. If you looked at whether it was the weak or even the moderate cases beforehand, margins were going to hold up reasonably well for a couple of reasons, a lot of your internal initiatives. Those drivers that were holding up margin, are those the same? Are you on a faster trajectory? Are you pivoting? Are you prioritizing some over the other? If you could share some of that, please?

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

Yes. Simeon, largely the same, roughly flat is what we've spoken to as it relates to gross margin over the course of the year. The puts and takes that we've talked through still relatively consistent. The headwinds from the supply chain expansion and investments in the Pro growth initiatives. The benefits and Bill covered this when he talked through merch productivity, higher private brands penetration, lower commodity transportation costs and then the pricing initiatives that we're working through. So those largely are going to drive the outputs. And then just from an SG&A standpoint, that's where we're going to see the bulk of the leverage, 40 to 60 basis points reflected in the new guide. That's going to offset the planned wage increases and the strategic investments. And then on the lower sales, just the change from the previous guide, it's mainly volume related.

Operator

Our next question is from the line of Steven Zaccone with Citigroup.

Steven Emanuel Zaccone - *Citigroup Inc., Research Division - Senior Research Analyst*

I wanted to focus specifically on the second quarter guidance just since weather has been so volatile. Is there any more detail you can provide about how the business is trending thus far in May would be helpful.

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

Steve, this is Marvin. I'll take that. So Steve, we would basically describe it as in line with our current guidance. The good news is, is as we've seen periods of more sustained seasonal weather, we've seen those seasonal categories respond in line to that. And that's geographically specific around West, South, North and East. But May is performing basically at our current guidance.

Steven Emanuel Zaccone - *Citigroup Inc., Research Division - Senior Research Analyst*

Okay. Appreciate that color. Then Marvin, I'm curious for your perspective on the potential duration of this weakness we're seeing in discretionary spending. What's your take on how long this potentially could last? There's a lot of macro cost currents at play. So just curious for your opinion.

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

Yes. It's a really good question and really to be quite honest with you, as you can imagine, we spent a lot of time looking at it, but it's just hard to predict. What we can say is that the overall structural drivers for home improvement remain really strong. And so we are bullish to the medium and long-term health of this business, things like the savings rate of consumers and you're looking at pent-up demand in the housing shortage, the age of homes. I mean, all of these things are still incredibly relevant. And when you think about the highest correlating factors to our sales, historically, they remain disposable personal income, home price appreciation and the age of housing side. So although we can't predict the duration of what we think will be a more short-term turbulence, but we think the medium and long-term health of this segment is incredibly strong.

Operator

Our next question is from the line of Brian Nagel with Oppenheimer.

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

So my first question, Marvin, just maybe a bit of a follow-up on the prior question. But just with respect to the commentary around discretionary, maybe can you give a little more color on what you're seeing? And how do you think about this weakness in discretionary relative to some of the weather disruptions. And then if you look here at Q1, is there anything really noticeably different than what we saw maybe in Q4 on the discretionary side?

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

So Brian, I'd give you some thoughts. I'll let Brandon jump in and provide any additional thoughts. But candidly, what we're seeing is pressure across big-ticket discretionary purchases primarily. We're seeing some pressure in small ticket, but it's more pronounced in big ticket and is almost exclusively discretionary in DIY. As you know, 75% of our business is penetrated in the DIY customer, and Q1 is our most discretionary quarter of the year because of all the seasonal purchases.

So when we run into timing of unseasonal weather, it has a disproportionate impact on our business. So we've been trying to pull apart the difference between discretionary pullback in weather-related non-spending. And so as we look at the month of May, as an example, we can start to see more clarity that when the sun comes out and the weather gets a more normalized kind of performance, as you would expect, the business in those discretionary categories have picked up. So that's why Brandon noted that we have an expectation we're going to get roughly $250 million back from delayed spring.

So for us, we're seeing discretionary big-ticket pullback primarily in DIY. The other good news for us is because our Pro-consumer and our target consumer is that small to medium-sized customer, that customer's backlog remains healthy and that customer spend has been relatively consistent. That's why we're able -- the positive comp in Pro for the quarter with over 800 basis points of lumber deflation specifically for that consumer.

Brandon, I don't know if you have anything else.

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

Brian, this is Brandon. I think just looking out a little bit beyond the weather that Marvin just spoke to, when we look at this topic of normalization, home improvement share of wallet, definitely seeing normalization back to services in terms of where discretionary purchases are going from consumers, travel, restaurants and a shift back to some necessity-based spend, groceries, gas, taking up a larger share of wallet given the inflation that we're seeing. But just as we look at the business at a broad level, units transactions well documented back in below, in some cases, to 2019 levels. But as Marvin mentioned, really nuances within that.

We're seeing Pro categories, in particular, building materials, rough plumbing, lumber has been a great story with what we've been able to drive with units and then categories like appliances where we've continued to grow units and shares. So all that combined, we are very optimistic in the medium to longer term that the categories where we've seen reversion or normalization, we got a new baseline there to which -- to manage the business. And then in these other categories that are out running, we can continue -- confidence that we can continue to take share there.

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

That's very helpful. I appreciate it. And maybe a follow-up separately, interesting comments about your rural stores, your strategy there. Anything you could say to help us better size this opportunity? Where are those -- the volumes are those units now versus maybe the chain average of some of your larger volumes? And then as you think about this re-merchandising effort, I mean, how much could that add and over what time frame to store volumes there?

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

Brian, what I'll do and I'll let Bill give you just some specifics on some of the categories that we're adding. And again, we piloted this for over a year to get the mix right, to get the assortment right. And we came away extremely pleased with the pilot results and thus, we identified roughly 300 stores that we're expanding this too, but I'll let Bill give you some specifics on those categories and what we believe that we can get from them.

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

Yes. And Brian, this is Bill. And so in my opening remarks, I mentioned some of these key categories in areas like pet. And we think there's an opportunity in these rural markets to do more in that category. There's opportunities with apparel. And so the launch of our -- the Carhartt brand, Wrangler brands gives us an opportunity to do something there in those markets. And then you think around livestock and really livestock feed as the consumer is looking for options from us to be able to serve that consumer. And then you can get into areas like fencing and some of these small fence that folks will use. And we're finding some interesting things with water troughs that are being used, certainly to water livestock, but they're also being used as a decorative piece for consumer's home where they're planting flowers in it.

So just a lot of interesting stuff that we're starting to learn here that the customer has given us a lot of credit for and wants to see Lowe's carry in their community. And that was part of the early pilot in those few stores that has allowed us to accelerate to get it to 300.

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

And Brian, this is Marvin again. Just last point on that. Both Bill and I grew up in rural parts of the country. Bill in rural Montana, I grew up in rural Tennessee and I think rural Tennessee is actually more rural than rural Montana, but that's for another discussion. We're seeing things like ATVs, we pilot it, having no idea if customers will respond. And it's been an incredible growth category for us. And in these rural markets, they are responding really well.

So a lot of learning, but what's also interesting is we are finding categories in these rural stores that we think will be relevant in nonrural locations, and that's been the beauty of this entire pilot and the strategy, and we'll continue to learn. But I'll just repeat what I said in my prepared comments, many of us, including me, and many in the marketplace perceive these rural and remote stores as a true competitive disadvantage to Lowe's, but we've now determined that, that is the opposite. We think that these stores give us incredible opportunities to not only grow top line with more improved sales per square foot but also just the operational profit opportunity with improved technology, improved omnichannel capabilities, improved efficiency. I mean, this is something that we're very excited about over the next, call it, 3 to 5 years.

Operator

Our next question is from the line of Seth Sigman with Barclays.

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

I wanted to just follow up on the May comment. I think you said it was consistent with guidance. I just want to clarify, does that mean consistent with the comment that Q2 would be at the upper end of the range. And then I think if you step back for a second, your original guidance had assumed some sequential improvement in the second quarter. Can you just remind us what some of the drivers of that were going to be.

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

So I'll take the first part on May. We tend not to give specific detail on current trends for all the obvious reasons. And so I'll leave my comments at May is performing at guidance, and we feel good about what we've seen, areas of sustained weather and how our seasonal categories are responding in those geographic locations, and that's reflective of May's performance.

And with that, I'll let Brandon answer the second part of your question.

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

Yes, sure, Seth. Just consistent with the upper end of guidance is what we referred to. And just the components again, the $250 million delayed spring benefit, the lumber deflation is going to step up. So a 350-basis point pressure in Q1, now expecting that to be 150 basis points in Q2. And just a reminder of the week shift benefit from Q1 is now flipping into Q2, and we expect that to be a $400 million drag. So those are just the components again, as it relates to Q2.

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

Got you. Okay. And then just a follow-up question on average ticket and inflation. It sounds like you still have some of the wrapping of the price increases from last year. But I guess, in general, how are you thinking about pricing going forward? Is there an opportunity to maybe roll some prices back? And maybe if you could tie in commentary around the elasticity that you're seeing in lumber. And I realize that category is a little bit different, but your commentary around the unit volume increase that you saw seem to be quite strong. So maybe just tie those 2 together.

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

Seth, I can take that as well. So when we look at the makeup in terms of ticket and transaction, as you mentioned, we're seeing the pace and cost increases. Those have slowed pretty dramatically here over the course of the last couple of quarters. We are still expecting a modest level of product inflation as we look out at '23. Most of that is wrapped from pricing actions that we've taken in the second half of last year. We are -- ex lumber average ticket is actually up in most categories when we look at Q1. The lumber deflationary pressure is expected to continue to impact average ticket in Q2, but not as significant as Q1. And then when we look outside of commodities, we're not anticipating any meaningful deflationary pressure as we move through the year.

Mainly the pressure is going to be coming from what Marvin mentioned, the pullback in DIY discretionary which is going to put pressure on ticket and that's especially true in the larger ticket bucket. So all in, the makeup of the comp and the outlook assumes more pressure overall on transactions, and we expect the average ticket number to hold up.

Operator

Our next question is coming from the line of Kate McShane with Goldman Sachs.

Katharine Amanda McShane - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Is there a view, just given that you do cater to the smaller and midsized Pro, just that you can hold up maybe a little bit better given the industry backdrop. And with regards to market share, it sounds like there were some wins there during the first quarter. Have your share assumptions changed at all based on that for the year?

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

Kate, this is Marvin. I'll take the first part of Pro with Joe, and then we'll let Bill and Brandon provide some market share input. I would first say we're really pleased with our Pro strategy. We spent a lot of time in the last 4-plus years trying to refine this strategy but also being very disciplined on not trying to overreach beyond our capabilities. And that's why the small to medium Pro has been our target Pro customer, and we feel like we're gaining traction. Anytime you can face over 800-basis points of lumber deflation and comping up against a 22% growth last year and still deliver a positive comp, I think it sends a signal that we're making progress.

I'll let Joe talk specifically about a couple of the key initiatives that we rolled out that's gaining the most traction and while we feel confident that we can continue to take market share in that segment.

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

Thanks, Kate, for the question. And as you look at the makeup of our Pro, it is on that smaller side. And as we rolled out our MVP Pro Rewards program, we're really seeing the Pros engage with us in our loyalty, our credit programs, of course, when they are engaged there, they spend 3x more than those not engaged. We've rolled out new CRM insights so we can better anticipate the Pro's needs. We can build those relationships. And with the loyalty program and the CRM system, they continue to improve as they mature. And so really excited about the unlock that is still ahead. Very pleased with the Pro LTR that we're seeing as a result. So we feel we're in a good place.

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

And Kate, before I hand it to Bill, I'll just add one additional thing. We did a recent survey in April of our Pro customers and then 75% of those customers came back and their backlogs were still healthy compared to Q4 and that gave us confidence that we still believe that we can grow market share and grow to extra market with this specific customer segment.

So Bill, you can talk about market share.

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

Yes. So when you look at market share, obviously, it's hard to measure home improvement share specifically, but we try to triangulate using data from NAICS, track line, other data, relevant market and broader market data. And then we look at our performance, obviously, in key categories like we've mentioned in our prepared remarks in areas like appliances where we've had unit growth feel like we're picking up share there in addition to the Pro growth that we've had and the continued acceleration with our online business, gaining traction with private brands, all of that and those elements kind of give us confidence that we're gaining some share here in these key categories. And when you see a positive growth in areas like paint, we also feel like we're gaining share in those areas as well.

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

Bill, the only thing I would add is just really pleased with the execution of Total Home strategy. You talked about Pro, positive comp with an 800-basis point drag on top of 11 consecutive quarters double-digit growth, really pleased with the online performance at plus 6%. So clearly, as we look at share gains, both for relevant market and broader home improvement, confident in what we're seeing. And it gives us confidence when we look at the broader market and our ability to grow 100 to 200 basis points above the market and growing Pro 2x when we look at 2023 and beyond.

Operator

Our next question is from the line of Jonathan Matuszewski with Jefferies.

Jonathan Richard Matuszewski - *Jefferies LLC, Research Division - Equity Analyst*

First one was on the rural pilot, Marvin. You've talked about localization for a couple of years now. A lot of the commentary in the past has been removing lawn mowers in Brooklyn, patio sets in West Philadelphia, deck stain in Scottsdale, when we think about this initiative here, it feels like it's a bit more strategic, more poised to benefit the top line versus limiting markdowns from the prior localization efforts. So if we go a bit deeper, is the benefit going to manifest itself more in terms of new customer acquisition or greater wallet share from existing customers. Presumably, both but just trying to understand kind of maybe where it may be more weighted in those pilot stores? That's my first question.

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

Jonathan, it's a very good question. And I think it is a combination of both because in order to add these new categories, we're taking categories out. And the categories we're taking out are the ones that were most at risk of being marked down because of the lack of localization. We had a, what I describe as a peanut butter spread on our assortment planning because our tools was so inferior is almost impossible for the merchants to do any really specific localization.

So now we've improved our assortment planning tools, we now have the ability to execute the localization strategy as part of our Total Home strategy. And because of that, we now know what categories to pull out of these rural stores that were not productive and now we're adding in new categories, which will give us the ability to take the customer who's shopping us and shopping of the retailers because of the lack of broadness of our assortment, and we're getting a larger share of wallet of that customer, and we're also attracting a new customer that's now coming in because we're selling items, i.e., pet that we didn't sell before that they are now coming to us as a destination.

And so we think this is something that has lots of potential, not to mention as we also implement the technology with the retiring of this old legacy system and we can then put in self-checkout and we can put it in mobile devices and all the other technology advancements that Joe and Seemantini and team have developed is going to also drive increased productivity and profitability in these stores. So we think it's a really clear example of our strategy working and it all hinges on getting the localization right.

And Bill, I don't know if you have anything to add.

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

Just going to add, Marvin, that the early read in the test stores would tell us that we're getting a new customer coming in categories like pet, like apparel. Those are 2 of the -- 2 categories that we had early read on that said we were drawing a new customer to the door. And so that's exciting to see.

Jonathan Richard Matuszewski - *Jefferies LLC, Research Division - Equity Analyst*

That's really helpful. And then just a quick follow-up on regional trends. Any trends you're seeing in markets where housing prices have cooled a little bit. I think they were down a bit in April. Any discernible trends in terms of where you're seeing pressure, specifically in markets with cooling home prices?

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

Jonathan, you can imagine, we're paying close attention to that and the short answer is no. I mean, we're not seeing any disproportionate sales impact in some of these markets, and we are tracking these markets very aggressively and paying very close attention to all.

Operator

Just going to announce our final question, Kate, that's coming from the line of Steven Forbes with Guggenheim Partners.

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

I'll ask my 2 together just in the interest of time. The first one, guys, can you just expand on how the first quarter Pro comp compared to your internal expectations? Ex lumber deflation seems like a big highlight during the quarter. And I wanted to know if you sort of identified what drove the outperformance, whether it's simply wallet share or accelerated new Pro growth and then a quick follow-up is just around the progress against the OpEx productivity initiatives. Any quantification of where you are versus those OpEx productivity goals as of the first quarter and/or what the guidance implies for a year-end goal?

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

So Steven, I'll take the Pro question. I'll give Brandon the productivity question. The short answer is Pro did outperform our expectations. We -- candidly, we didn't anticipate 800 basis points of impact to lumber deflation for that specific customer. So the fact that we were able to deliver a positive comp, it actually exceeded our expectations. And I think it comes down to what you heard Joe mentioned earlier, and that is the maturity of our MVP Pro rewards program and our CRM tool, the increased Pro related national brands that Bill and his team have worked to get added to the assortment and our improved fulfillment capabilities that Don Frieson, the supply chain team in partnership with operations that really work to create a more seamless ability for Pros to get product and not to mention the improved digital capabilities that help to deliver a 6% online comp during the quarter as well. We take all of those things combined. And we believe that we'll continue to lean into those initiatives to drive continued market share gain. Brandon?

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

Yes, Steven, I'll speak to PPI. So very much in line with our expectations there. I mentioned earlier, 40 to 60 basis points of EBIT expansion plan this year. We have a really aggressive portfolio, a road map of initiatives across the business, across every function set to drive operational efficiencies. We've mentioned a few of those today. Store tech modernization, front-end transformation to name a few. So really aggressive plans, and we're very much seeing those come to fruition in line with how we've guided.

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

Thank you all for joining us today. We look forward to speaking with you at our Annual Shareholders Meeting this Friday and on our second quarter earnings call in August.

Operator

Thank you. This concludes the Lowe's First Quarter 2023 Earnings Call. You may now disconnect.