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LOW.N - Q2 2023 Lowe's Companies Inc Earnings Call

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OVERVIEW:

Company Summary

REFINITIV

CORPORATE PARTICIPANTS

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

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

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

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

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

CONFERENCE CALL PARTICIPANTS

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

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

Eric Bosshard *Cleveland Research Company LLC - Co-Founder, CEO, Co-Director of Research & Senior Research Analyst*

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

Scot Ciccarelli *Truist Securities, Inc., Research Division - MD*

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

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

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

PRESENTATION

Operator

Good morning, everyone, and welcome to Lowe's Companies Second 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. For the second quarter, comparable sales declined 1.6%. Our results were driven by a strong spring recovery, combined with continued growth in Pro and online, which helped to offset softer DIY discretionary spending and 160 basis points of pressure from lumber deflation.

Q2 also reflected the importance of our ongoing investments in our Total Home strategy. And despite an uncertain macro, these investments are paying-off with positive comps in Pro and 6.9% comparable sales growth online as we continue to improve our omnichannel experience. We're pleased that our core Pro customer to small to mid-sized Pro remains resilient and continues to respond to our expanded national brands, MVP's Pro Rewards program and enhanced online tools. In our most recent survey, nearly 75% of Pros reported healthy project backlogs and lead volumes remain consistent with recent quarters. This quarter, we launched a new same-day delivery option on lowes.com and our mobile app powered by Onerail, enabling us to tap into their network of 12 million drivers to deliver directly to Pro job sites and consumer homes in a matter of hours. This new capability allows us to leverage our 1,700-plus store footprint to make those much needed last-minute deliveries to Pro job sites, saving them both time and money.

Our expanded same-day delivery capability is the latest of many examples of how we are meeting our customers where they are and making home improvement shopping faster and more convenient for both Pro and DIY customers. We're also making strides in the rollout of our market delivery model for big and bulky products with 13 geographic regions now supporting more than 1,200 stores, and we are on track to complete the initial rollout by the end of the year. As we invest in what will drive our future growth, we remain disciplined in improving productivity through our perpetual productivity improvement initiatives or PPI.

In the second quarter, operating margin expanded 18 basis points, leading to diluted earnings per share of $4.56. A common misperception we hear is that our productivity journey must be close to its end as we've driven significant operating margin leverage since beginning our transformation 5 years ago. But the reality is we still have a lot of opportunity ahead. We're in the final phases of sunsetting our 30-year operating system, in addition to the productivity benefits of using intuitive touchscreens instead of hard to navigate green screens. This conversion gives us the modern foundation needed to quickly build and scale new omnichannel capabilities for the future. And we also continue to leverage our penetration of rural stores to drive sales productivity. We run these stores with a lower expense base than the rest of our portfolio and our ability to generate outsized operating margin leverage on sales growth is unique.

Specifically, the expansion of our rural product assortment, combined with the implementation of our PPI initiatives, make our rural and remote stores a competitive advantage for our company. Beyond the productivity initiatives underway in stores, our leaders across all functional areas are executing against dozens of PPI work streams to deliver sustained operating margin improvement. One example of this is in our supply chain where we are driving greater throughput with new mobile applications combined with automation and robotics to improve productivity, maximize speed and minimize damages. And we're piloting a new break pack process, which leverages automation to break down cases 5x faster, making it far more efficient to replenish stores. And as we drive productivity, we also continue to focus on sustainability as the two often go hand in hand. And we recently published our 20th corporate responsibility report, spotlighting our path to net zero emissions along with our investments in our associates and communities. As we speak with investors, many of your questions have centered on the macro environment.

And as a reminder, the 2 strongest demand drivers of our business are real disposable personal income and home price appreciation, and they are most supportive of demand when they pull in tandem. Home price appreciation has slowed, but it's still up 35% versus pre-pandemic while rural disposable income has been pressured by persistent inflation and elevated interest rates. But on a positive note, over the past quarter, growth in real disposable income started to improve and realign with long-term trends with growing wages surpassing inflation for the first time in 2 years. Consumer sentiment has also improved slightly but remains below pre-pandemic baselines, and inflation concerns linger. However, improvements in sentiment typically must be sustained for a period of time before that translates to consumer spending. As a result, home improvement shoppers remain cautious with their spend, especially big-ticket discretionary purchases and are more focused on smaller repair and maintenance projects. These trends are consistent with our expectations and reinforced our outlook for our relevant market to be down mid-single digits in the second half of the year with our sales continuing to outpace the market by 100 to 200 basis points.

Looking ahead, it's encouraging to consider that home improvement projects are typically postponed rather than canceled. And home improvement spend as a percentage of home equity is below the historical average, a positive indicator for medium-term demand as consumer sentiment improves. The aging housing stock will also drive remodel and repairs, combined with other favorable trends like millennial household formation aging in place and persistent remote work. All of these factors continue to make us bullish on the mid to long-term outlook for our industry.

In closing, we remain a customer-centric company focused on our daily execution while also ensuring we continue to make the right investments to take share in any macro environment. Our total home strategy is resonating with our Pro and DIY customers alike, and we are confident in our ability to deliver in the short and long term. As I'm out visiting stores, each week I continue to be impressed by our hard-working frontline associates, and I'd like to thank each of them for their commitment to Lowe's and their communities.

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. Our second quarter comparable sales were down 1.6%, slightly above expectations. We successfully recovered $300 million of delayed seasonal sales from Q1 due to the late start to spring, $50 million more than anticipated. We saw growth in rough plumbing, building materials, paint, seasonal and outdoor living, lawn and garden and hardware as we captured these spring sales and continue to see solid broad-based Pro demand. These factors partly offset 160 basis points of lumber deflation as well as continued pressure on big-ticket DIY discretionary demand that Marvin mentioned earlier. In Hardlines, we drove broad-based sales growth driven by our stronger-than-expected spring recovery.

Lawn and garden was a standout category achieved in partnership with our live good vendors who helped us effectively respond to changing weather patterns and stretch spring into the summer months. We saw an increase in smaller instant gratification projects that improve outdoor spaces at an affordable price, like landscaping projects and pre-potted plants. Seasonal and outdoor living also benefited from the weather recovery where we saw momentum in outdoor power equipment, specifically in riders with the strength of our exciting products from John Deere and Aaron's, along with the battery-powered equipment from the strength of EGO, Kobalt and Craftsman. And we are pleased with our strong seasonal sell-through putting us in a better inventory position than last year as we move into the second half. Hardware was another top-performing category this quarter as our associates drove attachments alongside the higher lumber units and leaned into fastening with key brands like SPAX, GRK, Power Pro One and FastenMaster.

In tools, we started the rollout of Klein Tools, the #1 tool brand for electricians and HVAC professionals. We are excited about the launch of this brand, which is returning to Lowe's after nearly 15 years. As part of this launch, we will offer the largest assortment of Klein Tools anywhere in the home improvement retail channel, featuring hand tools, storage, safety and electrical products in-store and online, positioning us as the go-to retailer for these brand loyal customers.

Within home decor, paint delivered the strongest comp performance this quarter as we gained traction with the Pros who paint. These Pros are increasingly taking advantage of our MVP's paint rewards program, paint job site delivery and our new Spec Right paint designed specifically for Pros.

Turning to appliances. We continue to outperform the market. We've seen a return to pre-pandemic levels of vendor-funded promotions that are pressuring average tickets across the industry. But I'm excited about the traction that we're gaining as the leading appliance retailer in the U.S. reflected in our unit sales growth, market share gains and the momentum with our Pro customers once again this quarter. One encouraging trend was the increase in bundled appliance purchases. This was fueled by focused Red Vest associate selling, auto applied supplier rebates, faster fulfillment through our market delivery model and our improved online customer experience.

Now shifting gears to building products. We continue to see strength in key Pro categories, helping offset the pressure from year-over-year lumber deflation. While lumber deflation pressured our top line by 160 basis points and our Pro comps by 315 basis points, the category once again delivered the highest unit comp in the company this quarter, reflecting strong Pro demand. Our continued growth in building materials and rough plumbing is another positive indicator of the resilience of the small to midsized Pros supported by the healthy backlogs Marvin mentioned earlier.

In rough plumbing, we expanded our assortment of PEX products and added our first battery-powered Kobalt Drain Auger. This is one of several new Kobalt launches this year as we celebrate this private brand's 25th anniversary. Our private brands are spec'd out and quality tested to ensure that they are equal to or better quality than comparable national brands and we continue to see our customers respond to their great quality and value. Our increasing private brand penetration is nicely balanced with a strong lineup of trusted national brands like Bosch, DEWALT, Rubbermaid and Scotts.

Shifting to localization. We completed our rural expansion to roughly 300 stores ahead of schedule this quarter. This includes scaling our store within a store concept with Petco designed to provide a dedicated space for all things pet. While it's still early, we're encouraged to see an increasing basket size in these stores and customers are saying that they appreciate the convenience and the ability to reduce the number of stops they need to make. As Marvin mentioned, our work to optimize our rural stores is one piece of our broader localization strategy, designed to drive market share gains, increased productivity and margins. Another highlight this quarter is the growth we've driven online as we continue to improve the digital shopping experience and increase conversion our launch of same-day delivery nationwide on lowes.com, and our mobile app is resonating well with our customers.

We also introduced a new digital will this fit capability that helps customers determine if a refrigerator will fit into their space and a refined search experience with better recommendations, filters and featured categories. And our Halloween and holiday sets are already available online, positioning us nicely for customers who want to get a jump start on decorating. We are also encouraged to see better-than-expected performance for our Lowe's One Roof media network, which is driving increased traffic to Lowes.com and generating results that are exceeding the industry average for our suppliers. Our media network is one of many merchandising PPI initiatives underway at Lowe's. The team is constantly working with our suppliers to find ways to take cost out as commodity prices and transportation costs have come down, and we continue to enhance our technology and processes to optimize pricing. We have also expanded our merchandising services team, or MST, to over 30,000 associates across our stores and garden centers, which frees up our Red Vest associates to spend more time serving customers. New this year, we are adding MST assistant store managers. This role will be focused on providing dedicated store leadership for the critical work that this team does. Through their improved service, the team is squarely centered on driving sales per square foot productivity in our stores while creating a better shopping experience for our customers.

As I close, I'd like to once again extend my appreciation to our vendors and merchants for their hard work and partnership. Thank you, and I'll now turn the call over to Joe.

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

All right. Thank you, Bill, and good morning, everyone. I'm really pleased to begin by announcing that we are awarding over $100 million in bonuses for our frontline hourly associates in recognition of their hard work and dedication during the second quarter. Our investments in our associates are paying off as we continue to elevate the customer experience with a 200 basis point improvement in both our DIY and Pro customer service scores this quarter as compared to last year, and we are seeing strong staffing levels and improved associate engagement as we continue to invest in associate wages and ongoing development through Lowe's University.

As Marvin mentioned, our online comp sales grew 6.9% in the quarter, and roughly half of those orders are picked up in a store. We continue to unlock productivity through one of our many PPI initiatives by reducing the time to pick these orders by approximately 70% as our associates leverage our omni-channel investments, which include mobile devices and order picking carts with mobile printers to streamline the process. And we've enhanced our workforce management tools to better align staffing levels with customer demand. These enhancements are allowing our customers to get in, get what they need and get back to their projects faster. Looking ahead, we are further enhancing our BOPIS experience as we transform the front end of our stores. This includes an expanded staging area, a dedicated pickup desk with improved signage and new technology that expedites the process.

Now shifting to Pro. We continue to deliver positive comps this quarter despite lumber deflation. And under the leadership of our new Executive Vice President, Quonta Vance, we will continue to expand our online business tools for Pros that allow them to easily generate quotes and track orders as part of the MVP Pro Rewards program. As we continue to find ways to save Pros time, this month, we launched our newest online tool purchase authorization. Until now, when Pro sent a crew member to the store to pick up an order, the designated buyer would need to call their team from the checkout line to confirm the order and have it authorized by the store. This could be a time-consuming process, taking the Pros time away from their job site and the associate's time away from serving other customers. Now runners can simply scan a QR code that's pre-authorized up to a specified amount and check out without having to wait in line at the Pro desk. This solution addresses a pain point for many Pro customers and our Pro desk associates and leapfrogs the competition. And we're encouraged to see that our suite of online tools is resonated with Pros and adoptions is already exceeding our expectations.

Now I'd like to spend a moment discussing how we are managing shrink, which is a big responsibility for any retailer, especially in this environment. As expected, shrink was in line with last year's results despite industry-wide challenges, driven by our proactive customer service, tech-driven solutions, industry-leading asset protection program and our penetration of rural stores. We're developing radio frequency identification or RFID technology embedded in power tools to prevent theft. This solution will be largely invisible to customers, but it makes a tool inoperable until it is scanned and purchased.

Turning to PPI or perpetual productivity improvement in store operations, we have a series of exciting initiatives on our road map that will continue to deliver productivity for the company. In addition to the omni-channel enhancements that I mentioned earlier, we also upgraded freight flow process for shipments from our distribution centers into our stores and on to the selling floor. Through improved technology, we now have better visibility into how freight is flowing into our stores.

This enables us to better match staffing levels with the type of inbound freight, getting the product onto the shelves faster. These PPI initiatives, combined with our continued investments in our associates have helped us to control our expenses and improve our customer service scores in a down sales environment.

Before I close, I'd like to extend my appreciation to our frontline associates in Kentucky, New York and Vermont, who supported flood relief in their communities and to our teams in Hawaii, who are responding to the devastating wildfires. To support the recovery efforts in Maui, we are donating $1 million to provide food, emergency shelter and relief supplies to those affected and are grateful for our frontline associates for going above and beyond to help those on the island with recovery and cleanup.

With that, I'll turn it over to Brandon.

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

Thank you, Joe. Let me begin with our Q2 results. We generated diluted earnings per share of $4.56. Q2 sales were $25 billion. As a reminder, prior year sales included $1.7 billion generated in our Canadian retail business. Results also reflect a $335 million sales headwind and due to the shift in our fiscal calendar as we cycle over a 53-week year. As Marvin mentioned, comparable sales were down 1.6%, which includes approximately 160 basis points of lumber deflation. This pressure was partly offset by a 125 basis point benefit or $300 million of seasonal sales delayed from Q1 due to a late start to spring. Although the calendar shift pressured total sales growth in Q2, it had no impact on comparable sales as comps are calculated based on weeks 15 to 27 in fiscal 2022. Comparable average ticket was up 0.3% to prior year. Ticket increases in the majority of our merchandise categories were offset by lumber deflation and more normalized appliance promotions. Comp transactions declined 1.9% driven by continued pressure in DIY discretionary purchases, partly offset by our seasonal recovery. Our monthly comps were down 1.2% in May, 1.6% in June and 2% in July as the seasonal recovery was concentrated in the first half of the quarter. Gross margin was 33.7% of sales in the second quarter, up 42 basis points from last year. Gross margin benefited from our ongoing PPI initiatives, favorable product mix and lower transportation costs. These benefits were somewhat offset by costs associated with the expansion of our supply chain network and as expected, shrink was in line with prior year.

SG&A of 16.4% of sales delevered 16 basis points, largely due to lower sales related to the shift in our fiscal calendar. Please note that it also includes the benefit of a one-time legal settlement. We continue to tightly manage expenses, adjusting spend appropriately to align with demand, all while still improving our customer service. Also, as you heard from Marvin, Bill and Joe, we are pleased with the ongoing momentum we are experiencing across our portfolio of PPI initiatives, which continue to create significant value for the organization and helped offset the impact from lower sales.

Operating margin rate of 15.6% of sales levered 18 basis points, consistent with the expectations we outlined on our last call. The effective tax rate was 24.6%, in line with the prior year. Inventory ended the quarter at $17.4 billion, $1.9 billion lower than the prior year quarter. U.S. inventory units were down 3% compared to last year as we continue to manage replenishment in line with sales trends.

Now let me turn to capital allocation. In Q2, we generated $3.5 billion in free cash flow and returned $2.8 billion to our shareholders through a combination of dividends and share repurchases. During the quarter, we repurchased 10.1 million shares for $2.2 billion. In addition, we paid $624 million in dividends at $1.05 per share, and we announced a 5% increase to $1.10 per share for the dividend paid on August 9. Capital expenditures totaled $385 million as we continue to focus on high-return projects that support our growth objectives.

Our balance sheet remains healthy, adjusted debt-to-EBITDAR stands at 2.69x as we move towards our stated target of 2.75x in line with our BBB+ credit rating. Additionally, we delivered return on invested capital of 27.8%, inclusive of a 750 basis point impact related to transaction costs associated with the sale of our Canadian retail business and the discrete gain we reported in Q1.

Now turning to our 2023 financial outlook. As Marvin mentioned, we continue to expect our relevant market to decline mid-single digits this year and to outperform the market by 100 to 200 basis points. As such, this morning, we reaffirmed our full year 2023 financial outlook. We continue to expect 2023 sales in a range of $87 billion to $89 billion for the year, representing comparable sales of down 2% to down 4%. This includes a 150 basis point impact from lumber deflation for the full year. This outlook reflects continued strength in Pro and online, offset by ongoing pressure from DIY discretionary purchases.

Specific to our Q3 expectations, we will be cycling over the toughest comparison of the year as we delivered plus 3% comparable sales in the U.S. last year. Given these difficult comps, we are expecting Q3 sales towards the lower end of our full year guide. We continue to expect full year adjusted operating margin in a range of 13.4% to 13.6%, with disciplined expense management and ongoing PPI initiatives, partly offsetting the impact of lower sales volumes. And we are reaffirming our outlook for adjusted diluted earnings per share of $13.20 to $13.60. As a reminder, our full year outlook for operating margin and diluted EPS excludes adjustments associated with the sale of our Canadian retail business. And finally, we continue to expect capital expenditures of up to $2 billion this year.

In closing, I remain confident that the investments we are making in our Total Home strategy are positioning us to grow our market share regardless of the macro environment while continuing to deliver meaningful long-term shareholder value.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Chris Horvers with JPMorgan.

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

So first question is on the top line. What drove the difficult comparisons in the third quarter that you're not expecting this year? And then as you think about those bigger ticket DIY discretionary categories, how do you see the rate of change in those businesses? Are we starting to get to a baseline level that we can grow from? Or is that spending pattern still deteriorating?

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

Chris, this is Marvin. I'll take the first part, and I'll let Brandon take the second part. Look, when you look at last year, it's 2 different years, 2 different macro environments, 2 different sets of consumer sentiments. 2 different sets of expectations for DIY and Pro customers. I think the key point is that we feel good about the steps we're taking to grow market share regardless of the macro environment, we have a plan to outperform the home improvement market by 100 to 200 basis points, and that's what we're focused on. So I'll let Brandon answer the second part of your question.

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

Yes. Chris, this is Brandon. Let me get into a little detail on Q3 and second half. First, before I do that, let me take care of one quick housekeeping item as it relates to Q2 exit rate. There's some noise that we saw in the comp spreads across Q2 given the calendar shift that we experienced. And after adjusting those spreads to compare to last year Q2, comps are down roughly 1% in July. Also, when we look at July and August, they're traditionally lighter volume weeks until we hit the Labor Day fall seasonal period. So looking ahead at Q3 specifically, we are cycling our toughest comparable of the quarter, plus 3% last year in August, the toughest across that quarter at plus 4. And then your question on sort of puts and takes different from Q2. As we get into Q3, we won't see the same level of seasonal benefit. Going forward, we called out $300 million there that we experienced in Q2. More modest lumber deflationary pressure in Q3, which sized at about 75 basis points and then continuing to expect pressure in the DIY discretionary spend. And then on the flip side, continued growth and momentum from the Pro business as we expect to outpace DIY. So those are -- just to give you some insights as we look at Q2, and how we transition in Q3.

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

Got it. Makes sense. And then on the gross margin line, I know you had some price cost issues in the first half of this year. As you look ahead, given -- is that behind you? And as you think about how freight is going to start to roll through the inventory? Should gross margin performance improve in the back half relative to the first half?

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

Yes, sure, Chris. So gross margin bounced back as we expected. From Q1, we had easier product margin comparables due to prior year timing. The benefits, as you mentioned, the transportation cost relief is now flowing through margin as expected. We also benefited from product mix, and we continue to see great momentum with our PPI benefits across the merchandising portfolio. Those benefits are offset by continued investment in supply chain and the expansion specifically on market delivery. We called out shrink being neutral, as Joe mentioned, continuing to drive tech solutions to manage some of the industry-wide challenges there. And all in, as we look at the full year, we still expect roughly gross margins flat across the year. So puts and takes there, just like Q2, supply chain expansion continued pressure from some of the Pro growth initiatives. And then we expect continued benefits across the back half of the year from private brand penetration, supplier clawbacks, lower transportation costs and initiatives that we're seeing across the pricing portfolio.

Operator

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

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

We're at the halfway point of the year. I was hoping to take stock or diagnose the macro housing, Marvin, you mentioned that, and then also the consumer. Curious how it's playing out versus your expectation? It feels status quo, but wanted to hear the puts and takes on both sides.

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

Yes, Simeon. Look, I think you summed it up well. For us, when we look at consumer sentiment, I mean, we know that we're seeing a pullback in DIY discretionary spend. And that's really for us the kind of the overall theme of how we see the second half of the year. I think the good news for us is we remain really bullish on the mid to long-term view of the home improvement market, and we think it's still very healthy. I mean I can just give you the traditional data points that really matter, and we think that they're going to matter not only for home improvement in the mid to long term, but we think this is one of the best retail sectors to be in. You look at home demand, you had 2 million fewer homes than what's available for sale, the age of homes, 90% of homeowners have fixed mortgage rates in an environment where rates, as you know, are going up, and when we look at all the things that we're doing relative to Pro to DIY, we feel really, really comfortable that irrespective of the macro environment for home improvement that we're going to outperform the marketplace by 100 to 200 basis points. And key examples of why we believe that is when we take a brand like Klein tools that we have had absent from Lowe's for almost 15 years, and we can bring back the #1 brand for electrical and HVAC Pros and be the largest home improvement retail outlet for that brand, that gives us a lot of confidence that our strategy is working, and we're going to continue to grow market share across Pro and DIY. But the DIY discretionary pullback on big ticket drives our overall modest concerns about the back half. But even with that, we think we can outperform about 100 to 200 basis points.

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

That's helpful. The second question is more on margin, and this is maybe irrespective of what happens to sales, so both on SG&A per foot and even GM, you have the PPI as a good guy and then just in general spending levels. Can you talk about where PPI is? Is it performing better than you thought, and then is there any areas where you in hindsight should be spending more in or less for that matter just as we think about the margin progression going forward?

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

So, I'll take the first part, and I'll let Brandon add any additional context. What's interesting is that PPI started in store operations. I mean typically, you think about expense, it always begins in the store because of the amount of payroll we spend how we execute in our 1,700-plus store environment, but then the philosophy started to permeate around the entire company, merchandising, supply chain and across all those functional areas. And so because of that, we built a road map that Brandon and I could look at over a multiyear time frame, and we can understand the tech investments we're making and the expense reduction and the productivity that will be driven based on those investments. In addition to that, I don't want to understate the importance of our rural and remote stores, as I mentioned in my prepared comments and Bill mentioned in his we simply believe as we continue to identify ways to localize this assortment in addition to putting in technology and implementing PPI, we think it's going to give us a disproportionate benefit over the long term in driving operating margin improvement. And again, PPI is a big part of that. Brandon.

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

Yes, sure. Simeon, the good news too, when we look more in the short term around the back half of '23, we actually are expecting PPI to get more momentum in the second half than what we saw in the first half. A couple of really good efforts that are going on with new store tech architecture as we continue to build the modern foundation, enabling new capabilities in the store like omnichannel selling. We're transforming the front end of the stores with improved self-checkout, revamped BOPIS experience.

And then across the other areas, within merchandising. I mentioned earlier, pricing, private brand expansion and clawback and then also within the supply chain efforts as we continue to improve process and implement automation there. So all in, really pleased with the progress. We have those benefits factored in. They're going to continue to accelerate as we move across the second half of the year, and those are captured in our expectations.

Operator

Our next question is from the line of Elizabeth Suzuki with Bank of America.

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

Just a couple of questions about the assumptions of the guidance. So for the second half, you're assuming at the high end comps down about 1%, but on the low end, down about 5%. So I'm just curious what economic scenarios you're contemplating for both the high end and the low end. And then if trends you're seeing today continue, do you think you would end up on the higher end or on the lower end?

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

Yes, Liz, this is Brandon. I think as we think about our range for the full year, we believe the range is practical and it reflects a measured approach given the various potential scenarios and outcomes, we still -- as we look at the back half, still significant macro uncertainty, inflation, interest rates, a more cautious consumer especially on the discretionary side. There's also variables such as the student loans and the uncertainty there with the moratorium. So the team continues to be focused on executing the Total Home strategy. We believe Home improvement is going to be down mid-single digits, and we'll outpace that 100 to 200 basis points. We expect second half the softness with DIY discretionary to continue, and we expect to continue to see momentum from Pro and dotcom. So those -- that's what's reflected overall in our second half.

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

So Liz, this is Marvin. And this is a point I want to continue to reinforce. I mean, obviously, we're looking at the data that we have available, and we're looking at historical trends and how that data correlates to historical trends. But what we're saying is we're going to outperform the market by 100 to 200 basis points. So if we're being too pessimistic in the second half, that's great. because we're going to outperform that by 100 to 200 basis points. And so for us, we're really focused on controlling what we control, executing our Total Home strategy and just maintaining our organizational alignment and agility around whatever the macro throws our way. But we're just really confident as a team and the company that we have the agility to make sure that we continue to take market share irrespective of what the home improvement environment will be in the second half of the year.

Operator

Our next question is from the line of Zach Fadem with Wells Fargo.

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

So your average ticket slipped back slightly positive. We know lumber played a role, but considering this line is still 30% above 2019. Can you talk us through the moving parts here in a little more detail, and if you think it's fair to say that the average ticket has normalized or if there's still risk that you revert back closer to those '19 levels?

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

Zach, this is Brandon. Let me take sort of the ticket transaction narrative here. So on the ticket side, as we look at inflation, the benefits we expect to continue to normalize as we cycle a number of the price increases from 2022. As we look at new cost increases that are currently in our pipeline or inbound from our suppliers, that's effectively minimal at this point. There is some positive improvement in the average ticket and the expansion there that's not necessarily inflation driven as we continue to see healthy growth from our Pro customers and Pro penetration.

But punchline as we look across the second half, we're not anticipating meaningful deflationary pressure. We're going to see year-over-year lumber pricing is going to be much more normal across the second half, Bill mentioned, we're going to begin to cycle more normal appliance pricing, specifically as we get into Q4 and then the ongoing expectation with DIY discretionary is going to continue to put some pressure on ticket. So taking all that into account, our outlook assumes more pressure overall on transactions, and we look at ticket and expect that to really hold over the back half of the year.

Scot Ciccarelli - *Truist Securities, Inc., Research Division - MD*

Got it. And just over the past 2 years, your cost controls and operating margins have been able to show really nice progress even on a negative comp. And considering all the PPI commentary and host of structural changes, can you talk through what kind of margin progression we should anticipate as comps slip back to positive eventually? And if you think the expansion today could, in any way, preclude more meaningful expansion and recovery.

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

Yes. Zach, this is Brandon. I think, look, right now, we're really focused on delivering our expectations for '23. We've laid that out in the guidance. I'll reference back just as we your question around slipping positive comp. We laid out various scenarios back in December. We still, as we sit here today, confident in our path to continue to expand comps, top line through deployment of our total home strategy. We feel like we have a nice path going forward to expand operating margins. We've talked already at length around where we are from a perpetual productivity initiative standpoint, we're going to continue to make progress there. I'm confident, again, that we have the road map in front of us and all those building blocks are in place when we look beyond 2023.

Operator

Our next question is from the line of Scott Ciccarelli with Truist Securities.

Scot Ciccarelli - *Truist Securities, Inc., Research Division - MD*

Can you please talk about any regional differences you're seeing both in different parts of the country but also differentiation here between, call it, the rural locations you guys continue to reference as well as heavier urban locations?

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

Yes. So Scott, I'll take the first part. Look, I'd say regional differences, there's nothing material to speak to. I mean we know that housing and home prices ramped up pretty aggressively during the pandemic time frame in a couple of markets. But when we look at the overall geographic spread. I mean there are no real material differences between locals that had dramatically increase in housing costs and some of those costs are starting to moderate because you still have markets around the company country rather where home price is still going up. So we look at it, obviously, because it's one of those key internal macro indicators that we factor into our assessments, but there's nothing material to speak to.

Relative to urban and rural. We spent a lot of time talking about the importance of localization. And to say that Lowe's was a company that was not very localized 5 years ago would be an understatement. And as much progress as we have made, I think Bill will tell you that we still are excited because there's still lots of opportunity for us to be even more specific in how we localize from a rural and from an urban standpoint. I'm going to let Bill talk a little bit about our rural initiative and kind of what we're seeing. It's early days, but the early signs are positive. And I'll let him share just some general thoughts around those initiatives and kind of what we hope we'll continue to see.

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

Yes. Thanks, Marvin. And Scott, as I said in my prepared remarks, we got roughly 300 stores completed in the second quarter. Excited about what we're hearing from our consumers as they're giving us credit for the products that we're putting in there. We've been able to do some stuff around pet with our partnership with Petco, which we're excited about. We've also continued to learn and continue to listen to our customers. And so there's opportunities with different things related to that rural customer, whether that's utility vehicles, livestock feed, apparel, different types of products that they'll use every single day in and around their home. And so we're going to continue to learn. We're going to continue to adjust as we go, as Marvin said, kind of in the early innings of our localization opportunities. And on the urban side, we continue to adjust there as well, making sure that we're right for those urban markets, whether that's the types of products that they need for security and safety, whether that's areas in and around building codes and making sure that we can meet the Pro's needs in those markets, we're going to continue to tweak and adjust as we go forward. So excited about what we're doing on the localization front and what we're doing with rural.

Scot Ciccarelli - *Truist Securities, Inc., Research Division - MD*

Bill, just a clarification, if I can. On the rural side, like is it outperforming the urban areas now? Or that's the expectation as you wind up localizing more?

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

It's performing at what we expected it to perform.

Operator

Our next question comes from the line of Michael Lasser with UBS.

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

It's not the fairest metric, and there's a lot of noise in it. But if we simply look at Lowe's performance relative to its largest competitor over the last couple of quarters, Lowe's has been outcomping that player. Presumably, this quarter, it's in part due to Pro doing a little bit better online sales doing well, and maybe more seasonal catch-up as a result of leading higher -- harder into that category. So a, is that the right interpretation. And then b, how sustainable do you think that this measure of Lowe's performance is?

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

So Michael, I'll take that. This is Marvin. And I'll just be really honest with you. We spent a lot of time talking about the importance of being customer-centric. We don't pay a ton of attention to what's happening at our competitor because we believe if we take care of the customer, the customer takes care of everything else. So we're going to continue to stay focused on our total home strategy. We think if we do that well, then our results will be sustainable. And that means that we're going to be very localized. It means that we're going to be intentional around the small to medium-sized Pro that we're going to make our 1,700 stores connected to our customers via omni-channel, and we're going to continue to be intentional around what we do to give our associates a great place to work. Those things are most important.

And I think our results this quarter, although in a difficult market, reflect that our Total Home strategy is working, and we're continuing to invest the appropriate amount of capital to ensure that irrespective of the macro environment, we're not going to slow down on our investments in supply chain IT infrastructure, omni-channel and our Pro initiative. So for us, it's all about taking care of the customer, and that allows us to outperform our closest competitor, then that's just a benefit that we'll be more than willing to accept.

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

Understood. My follow-up question is on your view of the sales environment for the back half, understanding that you're still taking a prudently cautious stance given what's happening with macroeconomic indicators. Now with that being said, are you seeing any signs that those discretionary big-ticket purchases that had been weak, such as patio furniture, grills, other big ticket purchases are starting to stabilize? Or do you have line of sight that they might start to stabilize as you move into next year?

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

Yes, Michael, this is Brandon. Just a reminder, again, as we look out at the second half, we're cycling up plus 3% in Q3 of last year and a positive 0.7% in Q4. So that's been factored into our expectations. To your question specifically on DIY discretionary, we definitely saw the smaller ticket discretionary projects that were fueled by lawn and garden. We saw that benefit in Q2 as we get into second half, that seasonal benefit is going to subside. So some of the bigger, I'll call it, interior DIY discretionary areas, I would say, we're seeing very much performance here early on through August, similar performance with what we've seen over the first half. And that baseline performance is essentially what's reflected in our expectations for second half.

Operator

The next question is from the line of Eric Bosshard with Cleveland Research.

Eric Bosshard - *Cleveland Research Company LLC - Co-Founder, CEO, Co-Director of Research & Senior Research Analyst*

Two things, if I could. First of all, I guess probably for Bill, as you think about managing inventory and mix and promotions in this environment, how are you trying to position the business? Are you leaning in to try to drive traffic? Are you responding and perhaps a little bit more defensively, -- just how are you trying to position inventory mix and promotions?

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

Yes, Eric, first of all, thanks for the question. We're focused on trying to provide value to the customer every single day. And so that comes through lots of different things, making sure that from the Pro side that we continue to do things like we're doing right now as we roll out Klein tools in our stores, excited about that launch. We think that offers a nice opportunity for us is we'll have the largest assortment of Klein in the home improvement channel. So right now, we've got roughly 150 SKUs in the stores today. We'll have all of our stores set by the end of this week.

So that's just one way of being able to provide value to that Pro customer. And then from an inventory side, we came out of Q2 in better position with our seasonal inventories than we did a year ago. So that helps us. It allows us to invest as we go into Labor Day and fall planning and fall harvest, Halloween holiday, those types of things so that we can continue to provide value that way to the consumer with those holiday sets and Halloween sets provide a transition in the stores, as you know, and it gives the customer some excitement. And then we've got a lot of new stuff that we've talked about. We've got Coca-Cola that will finish rolling out in our stores being able to have access to that entire portfolio of product we're excited about. We'll roll out Carhart to 250 stores in Q3. So we're excited about getting that out there for both the DIY and the Pro. And then we'll have some new stuff in that spooky area for Halloween for the Halloween enthusiasts.

So all of that try to provide value to our customers in lots of different ways. And then offer them those promotional offers and appliances like you have to provide because over 100,000 appliances break every single day, and we want to make sure that we're relevant out there, and try to manage all of it in a portfolio approach. So we've got a lot of stuff going. We're excited about it, and we think will give us a nice way to position ourselves to drive value for our customers through the back half of the year and into next year.

Eric Bosshard - *Cleveland Research Company LLC - Co-Founder, CEO, Co-Director of Research & Senior Research Analyst*

Okay. And then second question, if I could. As you -- Brandon did a good job of explaining that you've kind of cycled through the price increases, and there's minimal from here. The math of the past couple of years has been price up more than volume has been down. I'm just curious how you all think about as price no longer goes up, the path for volume turning from a negative to a positive. I'm just curious how you think about that, and what makes that happen and perhaps when?

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

Yes, Eric, this is Brandon. I think again, focus right now on '23, as I mentioned earlier, we kind of breaking down transactions in ticket. We do expect pressure on transactions as we move across the balance of the year ticket to hold. I do think when we get on the backside of this, I'm not going to put a time frame on it, obviously, as there's a bunch of variables, a lot of uncertainty. It's too early for us to call what 2024 is going to look like. But I do think we are expecting a convergence in a better balance of transactions and ticket probably similar to pre-COVID levels as we start to look ahead across the long term.

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

This is Marvin. The only thing I'll add to that is we still are in the early innings of making what I would call best-in-class business operations in our omni-channel area, in localization and in just the overall technology infrastructure. I've mentioned that we're retiring a 30-year-old operating system. And not only will that make our stores a lot easier to operate from a technology standpoint, and what it does, it gives us incredible agility to build on top of that modern platform for more omni-channel capabilities. There's a lot of things we're doing today, the hard way.

And so I get excited because I can get out of bed every day, and I can see a long list of initiatives that we have yet to get to that's going to drive operating margin improvement drive space productivity and hopefully will drive top line as consumer sentiment continues to improve. So we're confident that we've not even reached a point of peak performance relative to the investment cycle that we have because we've been other places we know what world class looks like, and we know that we're on a journey to get there, but there are still areas of our business: Pro, online, fulfillment capabilities, space productivity that we know that we're still in the early innings. And so that's exciting, and we just have to do the work to make sure that we can achieve the expectations we have.

And Rob, we have time for one more question.

Operator

Final question will be from Steven Zaccone with Citi.

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

I wanted to circle back to your commentary about the appliance promotions, could you elaborate on that a bit more? It sounds new? What are your expectations for that side of the business in the second half of the year? And then just a follow-up on the promotions question earlier. It seems like the industry has not needed to be promotional. How long do you think this can last if big-ticket discretionary weakness continues?

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

Yes. So Steve, this is Bill. So just on the appliance side, specifically, what we've seen with appliances is that really, the industry has returned to kind of a more normalized go-to-market promotional offering, similar to what you saw prior to the pandemic. And so this normalization, as I said in my remarks, has put pressure on average ticket and average selling price across the industry. Everybody, I think, is feeling that impact. But essentially, we cycle this as we get into Q4, and we come -- we get into more of an apples-to-apples comparison when we get to Q4, but we're excited about the strength that we've seen with our appliance business. First quarter track line data would indicate that we took share in the first quarter. So we're driving units and trying to make sure that we can meet the needs of our consumers is, like I said, in Eric's question, 100,000 appliances break every single day, we've got to be there for our consumer. But it's not a radical shift to heavy promotions. It's more of a normalized promotion.

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

Got it. And then just question on the back half margins for you, Brandon. Given the commentary about same-store sales in the third quarter, is there anything to be mindful of in terms of gross margin or SG&A cadence in the third quarter versus the fourth quarter?

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

No. I would say, Steven, still expect 40 to 60 basis points of expansion. The one thing that I would call out. I mentioned we expect the PPI benefits to build over the second half. And then the second thing I'll mention is we are cycling over $400 million of associate discretionary bonuses that were paid out last year that we're not expecting to recur. So those are the big items that I would call out as we move through the second half.

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

And Steve, I would be remiss if I didn't just talk a little bit about our performance and shrink and the most difficult retail environment for shrink in my 35 years in this space. I want to let Joe just talk a little bit about the successes that we're seeing and how we hope that continues to support our gross margin forecast for the back half of the year.

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

Thanks, Marvin. And let me give you just a quick shout out to the store operations team and really our asset protection team. I believe they are best in class. And as you look across the actions that we've taken, whether it's in supply chain, whether it's on the front end with our new proprietary self-checkouts, replacing the MCRs, we have a best-in-class awareness platform. That's got a 92% voluntary participation rate. And that we have a line of sight for front-end transformations as we move into next year. The 100% execution of our high-strength program, where we've identified the stores. And so I feel really confident and just a great job by the team.

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 third quarter earnings call in November.

Operator

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