HIGHTOWER

FARR MARKET COMMENTARY

WITH MICHAEL FARR, HIGHTOWER'S CHIEF MARKET STRATEGIST

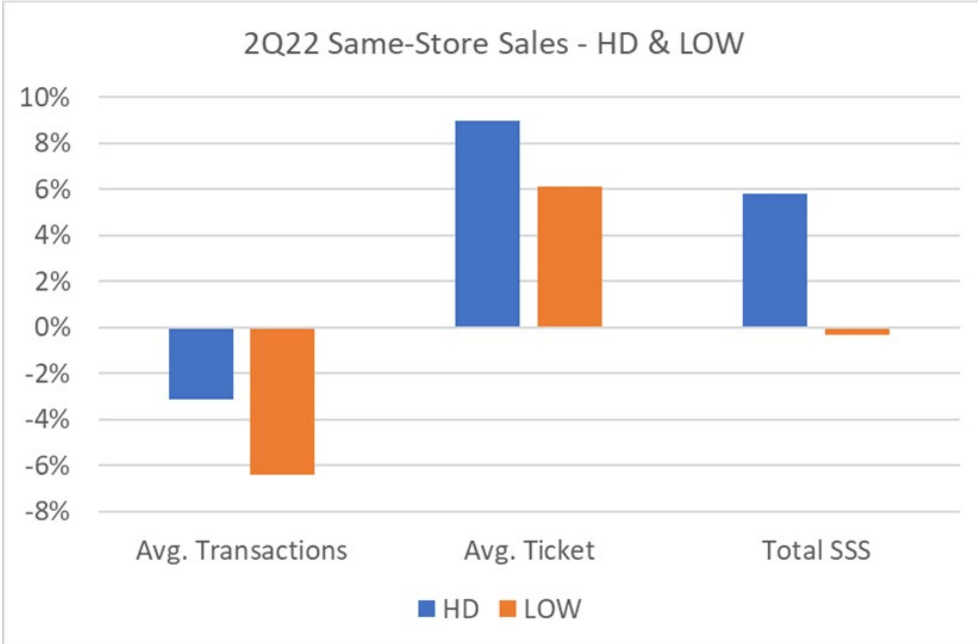
Is the Home Improvement Boom Dead?

August 18, 2022

This week we received second quarter results from home improvement giants Home Depot[1] and Lowe's[2]. Results for these companies are important because they can be useful barometers for the health of the US housing market, the US consumer and the US economy at large. And given that HD and LOW are down 23% and 18%, respectively, from their all-time highs in late 2021, investors were hoping the results would lay some of the worst fears to rest about the near-term fate of home-improvement retail. So did the companies deliver the goods?

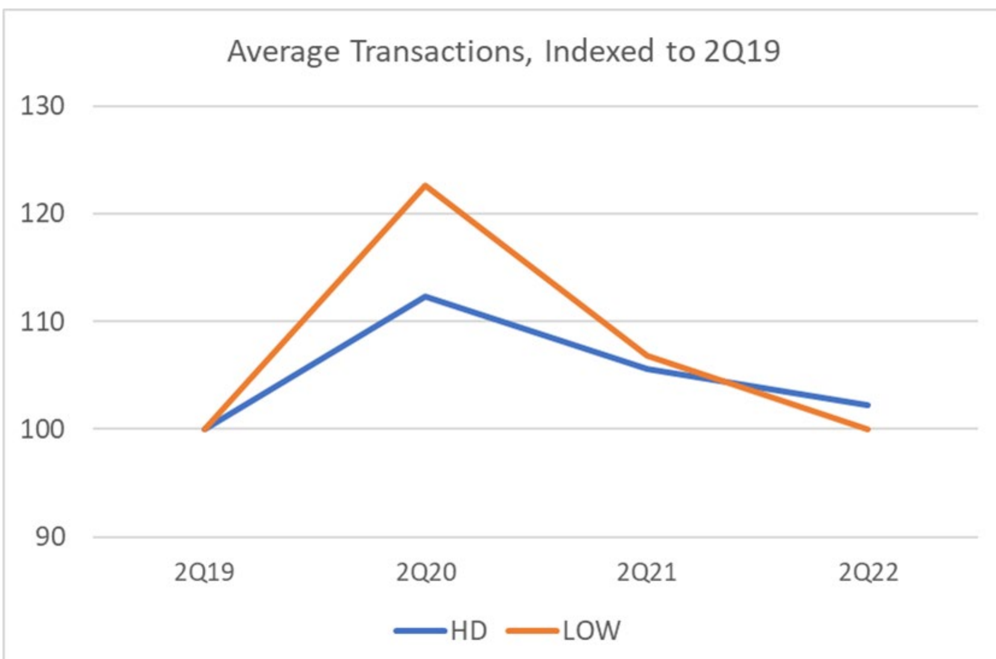
The first chart below shows one of the primary concerns among investors in the retail sector, especially home improvement retail. Same-store sales are holding up, with seemingly solid growth from Home Depot (+5.8%) in the quarter and flat growth (-0.3%) at Lowe's. These figures are more impressive than they look because they mean that the strong growth in sales immediately following COVID's arrival in 2020 is being sustained. But the issue is that the strength is coming solely from higher ticket size while the number of transactions per store continues to contract. In other words, customers are spending more, but there are fewer of them. This isn't usually the recipe for sustainable sales growth.

[1] https://ir.homedepot.com/financial-reports/quarterly-earnings/2022
[2] https://corporate.lowes.com/investors/financial-information/quarterly-earnings/year/2022



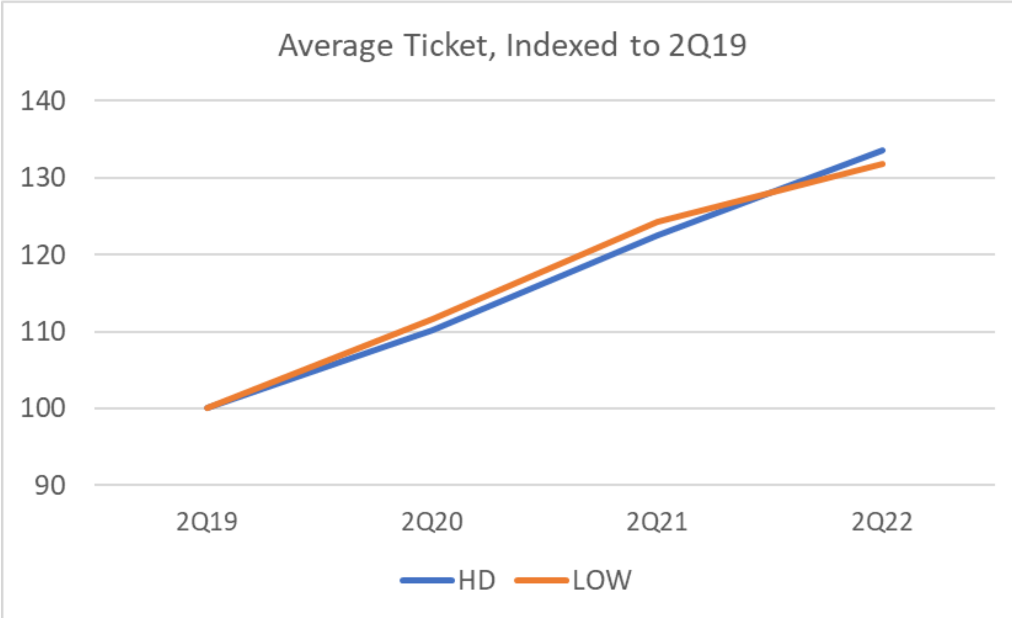
Source: Company earnings reports.

The next chart reinforces that point. Average transactions per store have declined in each of the past two second quarters at both HD and LOW. In fact, the number of transactions per store has receded back to 2Q19 levels.



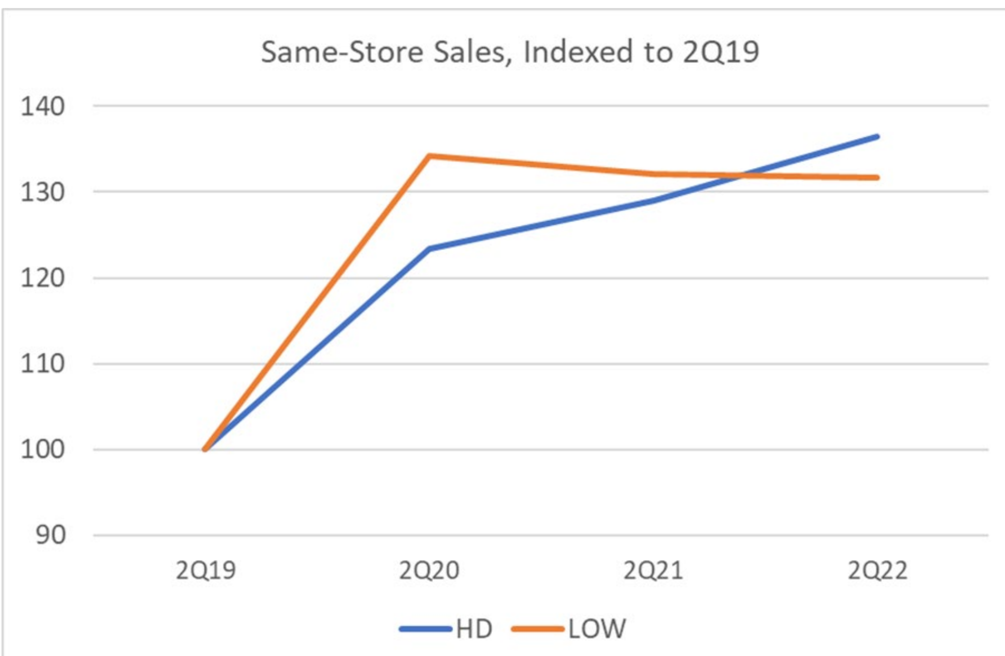
Source: Company reports.

Now for the good news. The next chart shows that average ticket size per store continues to surge and is up over 30% at each company over the past three years. Impressive!



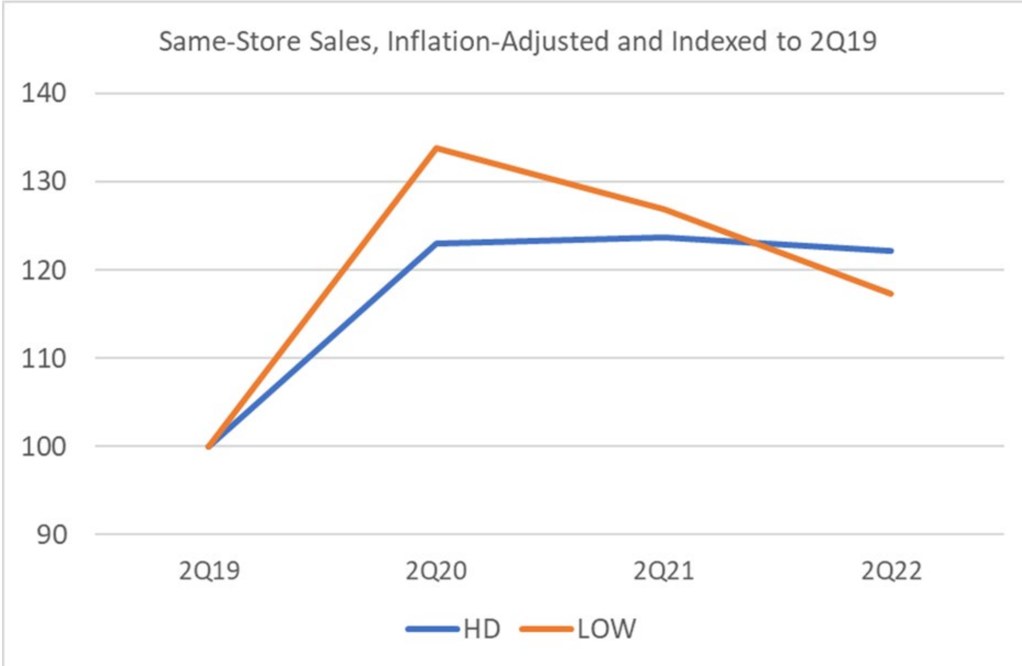
Source: Company reports.

The next chart shows the combination of falling transactions and surging ticket size. Following an initial surge in 2020 as consumers reacted to COVID by spending more on their homes, same-store sales growth has slowed dramatically at HD and has flatlined at LOW for the past two second quarters. This deceleration is the result of the drop-off in traffic at each company.



Source: Company reports.

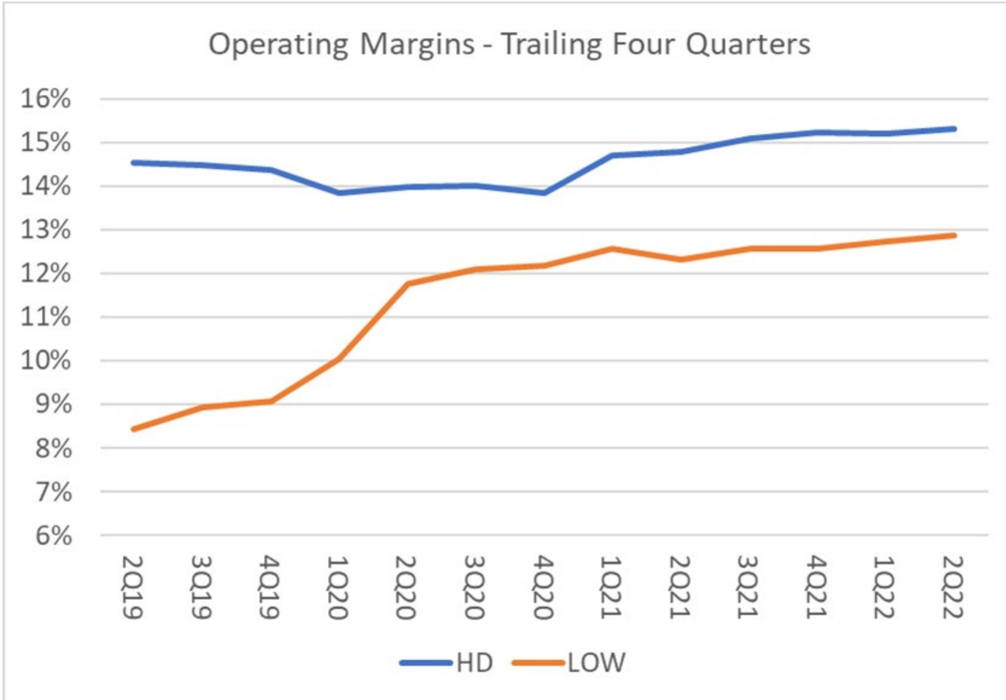
Investors are justifiably (in some cases) concerned that the sales growth being reported at many retailers simply reflects inflation rather than organic growth in the number of units sold. As you can see in the chart below, which shows same-store sales growth at each company after adjusting for inflation (and indexed to 2Q19 levels), inflation-adjusted same-store sales growth has been declining at LOW and has flatlined at HD for the past two second quarters. Much of the recent weakness simply reflects the insatiable demand for home improvement products during the throes of COVID. That surge in demand in 2020 is now moderating somewhat, but it needs to be remembered that even after adjusting for inflation, same-store sales at HD and LOW were still around 20% higher in the second quarter of 2022 as compared to the second quarter of 2019 (prior to COVID's arrival). Companies in many other sub-sectors of retail could only dream of such results!



Source: Company reports, Bureau of Labor Statistics.

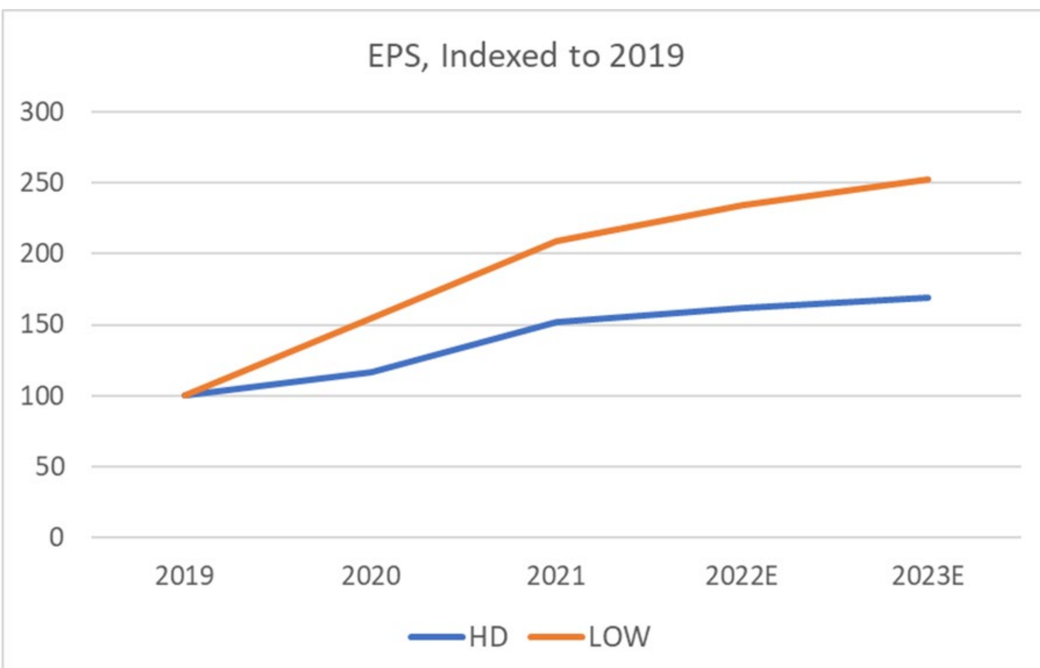
Another big concern about retailers is that some have built up big inventory positions that may require price reductions to clear. The buildup in inventory at some stores is the result of supply-chain bottlenecks, which are now starting to improve, and the failure to predict shifts in consumer spending following COVID. Specifically, there has been a shift from spending on physical stuff to spending on services and experiences. As consumers spend less on stuff, some retailers may feel the need to get inventory off the books through aggressive price reductions. As Target and Wal-Mart have shown, this process negatively impacts margins.

However, this doesn't appear to be the case at HD or LOW. Though both companies did post big year-over-year increases in inventories (due, in part, to inflation), their margins are so far holding up okay. And judging by management's guidance for earnings, it appears they expect that trend to continue. As an aside, I would note that those investors worried that LOW sales growth is not keeping up with HD sales growth need to take into consideration the margin trends at each company. Operational improvements implemented by Lowe's CEO Marvin Ellison have led to a closing in the margin gap between HD and LOW. So although LOW's sales growth hasn't quite been keeping up with HD, its growth in profitability has actually exceeded Home Depot's.



Source: FactSet.

And one final chart. At the end of the day, what really matters is earnings growth and the sustainability of that growth. You can see that analysts expect 2023 earnings at HD and LOW to be 69% and 152% higher, respectively, as compared to 2019 levels (the last year before COVID). And earnings growth at both companies is expected to be solidly positive both this year and next. This is a pretty phenomenal feat given the huge surge in demand for the companies' products and services immediately following COVID's arrival.



Source: FactSet.

For now, it seems like Marvin Ellison is correct that the health of the housing market and home improvement spending continues to be underpinned by solid consumer balance sheets, continued home price appreciation, the trend toward working from home (WFH), the aging of the housing stock, the trend toward aging in place (rather than moving to a new locale), and millennial household formation. Could that change in the future? Certainly, especially if mortgage rates reverse course again and head significantly higher. But for now, we believe the home-improvement retail sector deserves the benefit of the doubt and remains a relatively defensive place within the Consumer Discretionary.

Peace,

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