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BBY.N - Q1 2024 Best Buy Co Inc Earnings Call

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CORPORATE PARTICIPANTS

Corie Sue Barry *Best Buy Co., Inc. - CEO & Director*

Matthew M. Bilunas *Best Buy Co., Inc. - Executive VP & CFO*

Mollie O'Brien *Best Buy Co., Inc. - VP of IR*

CONFERENCE CALL PARTICIPANTS

Anthony Chinonye Chukumba *Loop Capital Markets LLC, Research Division - MD*

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

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

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

Joseph Isaac Feldman *Telsey Advisory Group LLC - Senior MD, Assistant Director of Research & Senior Research Analyst*

Michael Allen Baker *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Peter Jacob Keith *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Seth Mckain Basham *Wedbush Securities Inc., Research Division - MD of Equity Research*

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

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

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to Best Buy's First Quarter Fiscal 2024 Earnings Conference Call. (Operator Instructions) As a reminder, this call is being recorded for playback and will be available by approximately 1:00 p.m. Eastern Time today. (Operator Instructions) I will now turn the conference call over to Mollie O'Brien, Vice President of Investor Relations.

Mollie O'Brien - *Best Buy Co., Inc. - VP of IR*

Thank you, and good morning, everyone. Joining me on the call today are Corie Barry, our CEO; and Matthew Bilunas, our CFO.

During the call today, we will be discussing both GAAP and non-GAAP financial measures. A reconciliation of these non-GAAP financial measures to the most directly comparable GAAP financial measures, and an explanation of why these non-GAAP financial measures are useful, can be found in this morning's earnings release, which is available on our website, investors.bestbuy.com.

Some of the statements we will make today are considered forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. These statements may address the financial condition, business initiatives, growth plans, investments and expected performance of the company, and are subject to risks and uncertainties that could cause actual results to differ materially from such forward-looking statements. Please refer to the company's current earnings release and our most recent 10-K and subsequent 10-Qs for more information on these risks and uncertainties. The company undertakes no obligation to update or revise any forward-looking statements to reflect events or circumstances that may arise after the date of this call.

I will now turn the call over to Corie.

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

Good morning, everyone, and thank you for joining us. Today, we are reporting Q1 sales results that are right in line with the expectations we shared in March, and profitability that was better than expected, demonstrating our strong operational execution. We are appropriately balancing the need to adjust in response to the current industry sales trends with the need to invest so we can capitalize on opportunities as our industry moves through this downturn and returns to growth.

In this environment, customers are clearly feeling cautious and making trade-off decisions as they continue to deal with high inflation and low consumer confidence due to a number of factors. At the same time, in Q1, we saw our purchasing customer behavior remain relatively consistent in terms of demographics and the percent of purchases categorized as premium.

In addition, our focus on being there for our customers with expertise and support was highlighted by material improvements in satisfaction scores for our in-home services and delivery and record scores in remote support, in-home repair, store care and Best Buy Total Tech call center experiences, all key differentiators for us. We remain as confident as ever about our strong position in the industry despite reporting lower sales than last year. In Q1, our comparable sales were down 10.1% on a year-over-year basis.

From a merchandising perspective, similar to the past few quarters, the largest impact to our domestic comparable sales decline came from computing, home theater and appliances. The promotional environment played out largely as expected. It was slightly more promotional than last year, and we believe we are now fully normalized to pre-pandemic levels from both the percent of products being promoted and the depth of promotions.

In some products and categories, the environment was more promotional than we had expected, and we saw promotional levels above fiscal '20.

We effectively managed through those situations in partnership with our vendors. On a blended basis, our overall average selling price, or ASP, was slightly down to last year due to the return of promotionality. While we're on the topic, I would like to take a step back and address what we believe is a common misperception about our industry, that all products we sell are perpetually deflationary. In fact, most of our categories have had price stability over time or even see increases. The price of a product may come down in the year after it launches, only to be replaced by the next generation of the product launched at the same or slightly higher price.

Innovation drives price stability and often drives consumers to adopt even higher ASP products based on new technology or additional features. For example, the 5-year compounded annual growth rate for average laptop prices is approximately 2%. For Best Buy specifically, we over-index in the newest innovation and next generation of products so we tend to carry a higher ASP than the overall industry.

Additionally, as a reminder, structurally, our overall ASPs have also increased over the last several years due to category mix with the growth of higher ASP appliances and large TVs, as well as more mix into premium products at higher price points.

Now back to our Q1 results. Our inventory at the end of the quarter was down 17% compared to last year as we lapped last year's elevated levels. The team continues to manage inventory tightly, targeting approximately 60 forward days of supply. We expect that our inventory levels will continue to normalize and year-over-year variances will more closely match our sales performance as we move through the year.

In the first quarter, digital sales comprised 31% of our domestic revenue, very similar to the last 2 years and twice as high as pre-pandemic. Our buy online, pickup in store, percent of sales was also very consistent at just over 40%. Considering the speed of our delivery, with almost 60% of packages delivered within 2 days, we believe the consistency of our high in-store pickup by our customers really underscores the importance and convenience of our stores.

I continue to be proud of our team's execution and ability to navigate through this challenging environment, always keeping our customers and their experience as our top priority.

As we look to the rest of the year, we expect the macro environment to continue to pressure demand in our industry this year. However, our guide for the year implies that we expect year-over-year comp performance to improve as we move through the year, and relapse the comparable sales

declines we experienced last year. Based on what we can see right now, we continue to believe that calendar 2023 will be the bottom for the decline in tech demand. Matt will provide more color on our expectations later in the call.

This year, we are focused on delivering great customer experiences, while running the business efficiently and strategically setting ourselves up to flourish when the industry returns to growth. This includes our efforts to expand our gross profit rate and to continue to prudently manage our SG&A expense.

Now I'd like to update you on our membership program. The goal of membership is to drive increased customer engagement and increased share of wallet over time. As it relates to our paid membership program, our investment thesis remains very much intact. Our members are engaging more frequently with us, shifting their tech spending to Best Buy and buying more across categories than nonmembers.

Additionally, members rate our experience is higher. Our Net Promoter Scores from total tech members remain considerably higher than from nonmembers. No membership program is static, and we have always stated that it was our intent to iterate over time as we learned more. We've learned a tremendous amount from our members over the last couple of years, particularly that different customers value very different benefits when it comes to their technology.

Earlier this month, we announced changes to our membership program that align all our memberships and will give customers more freedom to choose a membership that fits their technology needs, budget and lifestyle.

In addition, these changes will provide more flexibility and result in a lower cost to serve than our existing Totaltech program. Starting June 27, our membership program will offer 3 tiers: My Best Buy, My Best Buy Plus and My Best Buy Total. I'll spend a few minutes going a little deeper on each of the tiers.

My Best Buy will remain our free tier plan, built for customers who want convenience. It includes free shipping with no minimum purchase and other benefits associated with a member account like online access to purchase history, order tracking and fast checkout. As you may recall, My Best Buy had historically been a points-based loyalty program. This past February, we added the free shipping benefit.

At the same time, we transitioned the ability to earn points solely to purchases made on our co-branded credit cards. The customer and financial impacts we have seen thus far validate our decisions.

For example, the online conversion rate for products under \$35 has increased, and our customer enrollments have remained steady. In addition, the early financial impact has been better than we modeled. My Best Buy Plus is a new membership plan built for customers who want value and access. For \$49.99 per year, customers get everything included with the My Best Buy offering as well as exclusive prices and access to highly anticipated product releases. They also get free 2-day shipping and an extended 60-day return and exchange window on most products.

My Best Buy Total is a membership plan built for customers who want protection and support. This tier is an evolution of our current Totaltech offer and is \$20 cheaper at \$179.99 per year. It includes all the benefits from the Plus tier as well as Geek Squad 24/7 tech support via in-store, remote phone or chat on all your electronics no matter where you purchase them. It also continues to include up to 2 years of product protection, including AppleCare+ on most new Best Buy purchases. Instead of free in-home installation and Holloway services, members will receive promotional offers from time to time.

As we reflected on the goals of our membership programs, we made this change because we could see that many customers who became members primarily for free installation services did not stay with the program as long as other members and had significantly higher churn. From a financial perspective, we continue to expect our membership program to contribute approximately 25 basis points of enterprise year-over-year operating income rate expansion in fiscal '24.

We have already begun to deliver on this expectation as the changes we made to the free My Best Buy tier benefited our gross margin rate this quarter.

Now I will shift topics to talk about our omnichannel operations. We are continuing to adapt our omnichannel capabilities to ensure we maintain a leading position in an increasingly digital age and evolving retail landscape. For example, our portfolio of stores needs to provide customers with differentiated experiences and multichannel fulfillment. At the same time, we need them to become more cost and capital efficient to operate while remaining a great place to work.

We are on track to deliver the fiscal '24 store plans we announced this past March. These include closing 20 to 30 large format stores, implementing 8 experience store remodels and opening around 10 additional outlet stores. Consistent with the plans we shared entering the year and incorporated in our fiscal '24 guidance, during Q1, we advanced our operating model to align with the ongoing evolution of our business model and current trends.

As I mentioned on our last call, over the past 3 years, our overall headcount has declined by approximately 25,000 people, or 20%, as we adapted to the shift in customer shopping behavior and in the effort to drive more flexibility. As a reminder, the vast majority of this headcount change came through the pandemic from attrition in our decisions not to backfill. Throughout these significant changes, we have been working hard to balance the amount of labor hours necessary to deliver the best experience possible for our employees, customers and shareholders. At the same time, we have been investing in tools and employee development programs that increase their flexibility within and across stores.

We also know that not all roles and the associated hourly pay are the same, and strategic trade-off decisions are necessary to give us the ability to flex our labor spend appropriately, particularly customer-facing labor.

Based on all these factors, we have been, as we've previously said, making multiple changes to our labor models. One such example is the recent change to our consultation program. By lowering the overall number of in-store consultants and designers, we were able to add approximately 2 million more hours for customer-facing sales associates into our staffing plan for the year. Customers are already giving us higher marks for improved associate availability in recent customer surveys.

It's also important to note that we are moving away from a one-size-fits-all approach to our stores and staffing to a market-based approach. And depending on the needs of each market, we're adding, removing, shifting or arranging the number of associates and roles needed to better and more efficiently serve those customers and to allow for more localized flexibility.

Looking forward, we will continue to iterate our model to align with business trends, including initiatives such as membership and ensuring the span of control of our leaders is appropriate. As you would expect, we are also focused on leveraging existing and emerging technology to drive better customer and employee experiences across channels that also deliver efficiencies and better margins. I'd like to share a few examples around our customer care phone experience and our in-home sales team.

Our customer care agents receive millions of customer phone calls every year. We recently launched a capability that uses generative AI to summarize the main points and follow-ups from each call. In the past, customer care agents manually took notes to capture interactions real time with customers. This new capability allows our agents to both fully focus on the customer during the call and reduces time between calls, lowering overall cost and improving agent satisfaction. In addition, this is providing us with valuable information about friction in our experiences, allowing us to continuously drive upstream improvements.

In another example, we're piloting a virtual reality training and simulation experience for our in-home consultants and designers. We expect this will decrease the cost to develop and certify in-home sales team, and elevate the specialized in-home selling skills of consultants and designers, especially those who are newer and less experienced. Additionally, these tools are always available for reference, whether a team member is in a customer's home or training in store.

Now I will take a few moments to share our thoughts on our broader industry backdrop. As I mentioned, we expect that next year, the consumer electronics industry will see stabilization and possibly growth following 2 down years. I believe it's worth repeating why we are confident our industry will return to growth.

First, we believe that much of the growth during the pandemic was incremental, creating a larger installed base of technology products in consumers' homes. On average, U.S. households now have twice as many connected devices as they did in just 2019.

Second, we expect to begin to see the benefit of the natural upgrade and replacement cycles for the technology bought early in the pandemic, possibly later this year, depending on the macro environment, even more likely in calendar 2024 and 2025. Historically, customers upgrade or replace their tech every 3 to 7 years depending on the category, with mobile phones on the lower end, computing in the middle and home theater and large appliances toward the higher end of that range. We continue to see our lapsed customers returning at higher rates year-over-year, especially as customers we acquired early in the pandemic return for additional technology purchases.

Third, this is not a static industry. Billions of dollars of R&D spend by some of the world's largest companies and likely some we haven't even heard of yet, means innovation is constant over the long term, driving interest, upgrades and experiments. We can see the customer demand for newness exemplified in the last few weeks by the record-breaking launch of the new Zelda software for Nintendo Switch and the stronger-than-expected preorders for the new ASUS handheld gaming device.

We continue to believe the industry will get back to a more normalized pace of meaningful innovation toward the end of calendar 2023 and into 2024. Additionally, there are several macro trends that we believe should drive opportunities in our business over time, including cloud, augmented reality, generative AI and expansion of broadband access. While our existing product categories have slightly different timing nuances, in general, we believe they are poised for growth in the coming years.

We are also furthering our expansion into newer categories like wellness technology, personal electric transportation, outdoor living and electric car charging. We carry multiple EV charging brands, and we were the first retailer to carry Tesla chargers. We also launched Starlink satellite Internet kits on our digital channels and will have it available in stores later this summer. In addition, we are partnering with our vendors in new ways that leverage our capabilities to create new opportunities. For example, we are partnering with Roku to make TV advertising more relevant and performance-driven.

The first-ever TVs to be designed and made by Roku are available exclusively at our stores and on bestbuy.com, and brands will be able to work with us to target, optimize and measure their ads on Roku using Best Buy audience data. We also continue to build our Partner+ program that leverages our supply chain and fulfillment capabilities. We have several vendor partners, including Samsung, who are offering their online customers the option to conveniently pick up their products at their local Best Buy store.

The recent launch of Oura Smart Rings is an example of how we partner with some of our smaller emerging vendors in a very comprehensive and unique way to drive customer engagement. Oura is a smart ring that uses sensors to track a variety of metrics to provide continuous health monitoring to improve the user's health habits. We launched the products exclusively on bestbuy.com and in 850 stores.

We have an interactive demo experience with the ability to try on the rings and order any configuration of style, color and size.

We also incorporated the Best Buy store finder on Oura's website so customers can visit their closest store and see the products in person. I want to extend my heartfelt appreciation for all our associates across the company who continue to uniquely position us for the future through immense change. We continue to focus on providing competitive pay and benefits and leveraging flexible work models. And I'm pleased to report that we maintain industry load turnover rates, particularly in key leadership roles, the vast majority of which we hire internally.

It's amazing to see so many of our key leaders choosing to build the future of retail with us. And I am proud of the many ways we were recognized during the quarter for our commitment to our people and the environment. We were included on DiversityInc.'s 2023 list of Top 50 companies for diversity and ranked 17th on DiversityInc.'s top companies for Board of Directors list, reflecting our ongoing work to ensure our leaders and our company reflect the communities we serve.

Just last week, we were listed on Parity.org's list of best companies for women to advance as well as their inaugural best companies for people of color to advance. We were one of fewer than 20 companies named to both lists this year. We were also recently named one of Barron's 100 most sustainable U.S. companies for the sixth year in a row. In fact, this year, we were the top-ranked retailer.

My summary is consistent with my comments last quarter. We believe the macro and industry backdrop will continue to be volatile this year. We have a proven track record of navigating well through dynamic and challenging environments, and we will continue to adjust as the macro evolves. At the same time, we remain incredibly excited about our future. We believe our differentiated abilities and ongoing investments in our business will drive compelling financial returns over time, and we are carefully balancing our reaction to the current environment, with a focus on our strategic initiatives and future. I will now turn the call over to Matt for more details on our first quarter financials and fiscal '24 outlook.

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Good morning, everyone. Let me start by sharing details on our first quarter results. Enterprise revenue of \$9.5 billion declined 10.1% on a comparable basis. Our non-GAAP operating income rate of 3.4% declined 120 basis points compared to last year. Non-GAAP SG&A was \$40 million lower than last year and increased approximately 180 basis points as a percentage of revenue.

Partially offsetting the higher SG&A rate was a 60-basis-point improvement in our gross profit rate. Compared to last year, our non-GAAP diluted earnings per share of \$1.15 decreased 27%.

While our revenue was down to last year, overall, our results, once again, align closely with our expectations entering the quarter. Our non-GAAP operating income exceeded our expectations due to both higher gross profit rate and lower SG&A. The better-than-expected gross profit rate included favorable supply chain costs and benefits associated with changes made last year for our free My Best Buy membership offering. The favorable SG&A was driven by a combination of several smaller items with store payroll expense being the largest driver.

Next, I will walk through the details on our first quarter results compared to last year. In our Domestic segment, revenue decreased 11% to \$8.8 billion, driven by a comparable sales decline of 10.4%. From a phasing perspective, February was our best performing month on a year-over-year basis with trends softening through the remainder of the quarter. From a category standpoint, the largest contributor to comparable sales decline in the quarter were computing, appliances, home theater and mobile phones, which were partially offset by growth in our gaming and service categories.

In our International segment, revenue decreased 11.6% to \$666 million. This decrease was driven by the negative impact of foreign exchange rates and a comparable sales decline of 5.5% in Canada. Our Domestic gross profit rate increased 70 basis points to 22.6%. The higher gross profit rate included the following: first, improvement from our membership offerings. This included a higher gross profit rate in our services category, which was primarily driven by the cumulative growth in total tech members. In addition, our rate benefited from the program changes we made last year to our free My Best Buy offering.

Second, product margin rates improved versus last year despite increased promotional activity. And third, the profit sharing revenue from our private label credit card arrangement was a benefit to our domestic gross profit rate. Overall, the results this quarter aligned with our commitment to improve our gross profit rate this year.

Our International non-GAAP gross profit rate of 23.7% decreased 60 basis points compared to last year, which added approximately 10 basis points of pressure to our enterprise results on a weighted basis. The lower international gross profit rate was primarily driven by a lower mix of revenue from the higher-margin rate services category.

Before moving on, I would like to give some additional context on the profit sharing revenue from our credit card arrangement, which we have now called out as a benefit to our gross profit rate for the last 8 quarters. In fiscal '23, the profit share was approximately 1.4% of domestic revenue, an increase of 50 basis points compared to fiscal '20. The growth was driven by the increased usage of our card both at and outside of Best Buy and a favorable credit environment. Our outlook for fiscal '24 assumes that profit share will have a slightly negative year-over-year impact on our gross profit rate for the remainder of the year.

Domestic non-GAAP SG&A declined \$29 million with the primary drivers being lower store payroll costs and reduced advertising, which were partially offset by higher incentive compensation and depreciation.

Moving to the balance sheet. We ended the quarter with a little more than \$1 billion in cash. Our year-end inventory balance was approximately 17% lower than last year's comparable period, and we continue to feel good about our overall inventory position as well as the health of our inventory. During the quarter, we returned a total of \$281 million to shareholders through dividends of \$202 million and share repurchases of \$79 million. Our quarterly dividend of \$0.92 was an increase of 5% and marked the tenth straight year of dividend increases.

We expect to continue share repurchases throughout fiscal '24. However, we are not providing a target. We will continue to assess our overall working capital needs and provide updates as we progress through the year.

Moving next to capital expenditures, where we still expect to spend approximately \$850 million this year. This reflects a reduction of approximately \$80 million compared to last year with lower store-related investments being the primary driver of the reduced spend.

Now I would like to discuss our fiscal '24 outlook. As a reminder, our original guide for this year assumes the consumer electronics industry would continue to feel the pressure of the broader macro environment and the high degree of uncertainty as it relates to the consumer.

Our financial performance in the first quarter closely align with our expectations, and we are maintaining the full year guidance we provided this past March. Given the current environment, we are, of course, preparing for a number of scenarios within our guidance range. At this point, we believe our sales align closer to the midpoint of the annual comparable sales guidance. It is still early in the year so we will continue to watch the trends closely and adjust as necessary.

Let me provide more details on our guidance and working assumptions. Starting with revenue, we expect Enterprise revenue in the range of \$43.8 million to \$45.2 billion and Enterprise comparable sales decline of 3% to 6%. As a reminder, the fourth quarter of fiscal '24 contains an extra week. We expect the 53rd week to add approximately \$700 million of revenue, and it is excluded from our comparable sales. Our guide implies comparable sales trends versus last year improve as we progress through the year.

Let me share context on that. Starting in Q1 of last year, our industry experienced the beginnings of macro pressure and the broader implications of normalizing consumer demand trends after 2 years of higher growth. This resulted in a 10% comparable sales decline for the full year. For the remainder of this year, we will continue to lap the industry pressure that only worsened from the first quarter of last year.

Furthermore, when using fiscal '20 as a comparison, you will see that our guidance implies revenue trends will further soften in the second quarter. After removing the estimated revenue from the 53rd week, the midpoint of our revenue guidance reflects a scenario where our growth, compared to fiscal '20, is slightly negative in the second quarter and regresses slightly more in the second half of this year.

This is clearly a continued slowdown in revenue growth compared to fiscal '20. For reference, our revenue growth compared to pre-pandemic fiscal '20 peaked at 27% in Q1 of fiscal '22 and generally has been slowing ever since, the last quarter at 4%.

Moving on to full year profitability guidance, which is, Enterprise non-GAAP operating income rate in the range of 3.7% to 4.1%, and non-GAAP diluted earnings per share of \$5.70 to \$6.50. Our outlook remains unchanged for a non-GAAP effective income tax rate of approximately 24.5% and for interest income to exceed interest expense this year.

As it relates to the extra week, we expect it to benefit our full year non-GAAP operating income rate by approximately 10 basis points. I will review the full year gross profit rate and SG&A working assumptions that we shared this past March. We expect to drive gross profit rate expansion of 40 to 70 basis points compared to fiscal '23 due to the following actions and initiatives. We expect to see benefits from optimization efforts across multiple areas, including reverse supply chain, large product fulfillment and our omnichannel operations.

We also expect our membership program and our health initiative to improve our gross profit rate. Lastly, we expect the impacts from promotions, supply chain costs and the profit sharing from our private label credit card, we have a relatively neutral impact to our annual gross profit rate compared to this past year.

Now moving to SG&A expectations. We expect SG&A as a percentage of sales to increase by approximately 100 basis points compared to last year. We expect higher incentive compensation as we reset our performance targets for the new year, and the high end of our guidance assumes incentive compensation increases by approximately \$225 million compared to fiscal '23.

Depreciation expense is expected to increase by approximately \$50 million and store payroll expense is expected to be approximately flat to fiscal '23 as a percentage of sales. As it relates specifically to the second quarter, we expect that comparable sales will decline in the range of 6% to 8%, which reflects a sequential year-over-year improvement compared to the first quarter. Our revenue growth trends during the first 3 weeks of the quarter improved from April and were within our Q2 guidance range.

On the profitability side, we anticipate our second quarter non-GAAP operating income rate to be approximately 3% or slightly higher. Lastly, we expect SG&A dollars to be approximately flat to last year, at the midpoint of our revenue range. I will now turn the call over to the operators for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Simeon Gutman from Morgan Stanley.

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

Nice job navigating in this backdrop. My question -- my 1 question is on industry growth, this idea that maybe we bottom this year. If you look at the category, it's more than reverted, to your point, Matt, around sales trends. It looks like it's overshoot in a way.

And you could have made the case that this year, '23, could have -- should have been sort of the bottom and even the turn. So what gives you confidence in '24 because once you overshoot, it's hard to determine where that bottom is? Curious if you can provide some more color.

Corie Sue Barry - Best Buy Co., Inc. - CEO & Director

Yes. Thank you, Simeon. Let me start with a little bit of the backdrop here. And I think we've been pretty consistent in saying we started really in Q2 of last year and saying the consumer is clearly making trade-off decisions in a very unique environment. So to your kind of original question on the reversion, I think what we would say is we've been seeing a consumer who is, whether or not you call it a recession, exhibiting some recessionary behaviors, depending on the different category that you're talking about. So it's absolutely unusual.

I think as we look ahead, we start to feel like you see the turn in the business as you head out the back half of this year and into next year. And there are a few industry sources that we're using to help substantiate that. If you look at NPD, CTA, Forrester, a lot of those have the same kind of point of use.

So first of all, we're just looking externally to say what do we see in the landscape. But I think we try to lay out even within the prepared remarks, there are some key tenets here that we believe underscore our thoughts for next year. One is, this idea of truly a larger installed base. Yes, absolutely, there was some pull forward in the pandemic, but some of that had to be incremental given you now have 2x as many connected devices in people's homes as you had versus just 2019. So you absolutely have this larger installed base of product. And these are not static products. These are products that we can already see our vendors working to upgrade and innovate and drive.

The second point that we made, which is replacement cycles, natural replacement cycle is 3 to 7 years, like we said, quicker on the mobile side, computing in the middle, appliances and TVs more on the high end. But these are pretty consistent replacement cycles that we see over time.

If anything, we saw them maybe accelerate a bit during the pandemic, normalize a bit more now. But on the whole, you've got products that, because of their nature, you're going to want to upgrade. And then the third is the pace of vendor innovation. And you can -- despite we gave some specific examples in the prepared remarks, you can already start to see some of that innovation coming. I think the window that we have into our vendors would say it's more towards the back half of this year and into next year. I think we were clear in the prepared remarks to say this is all based on what we can see now, and we're going to continue to evaluate. But as of right now, it feels like the consumer's kind of made their choices about the industry that we're in. And you still feel really well set up as we start to head into the next calendar year.

Operator

Your next question comes from the line of Joe Feldman from Telsey Advisory Group.

Joseph Isaac Feldman - *Telsey Advisory Group LLC - Senior MD, Assistant Director of Research & Senior Research Analyst*

I have a couple of quick follow-ups for you. With regard to the incentive comp for this year, can you help us out why it would go up as much as it is given it's such a challenging year? Not that you guys shouldn't get paid, but I just wanted to better understand.

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Yes, sure. First of all, I'll take you back to last year. Last year, we had about \$455 million of favorability in incentive compensation. As you think about last year, by the end of last year, we had essentially not paid out any of our incentive comp based on our annual performance last year, a lot of which is driven by revenue and operating income expectations as you enter the year.

And so essentially reversed out all of that expense last year. And so as you set new targets for this year FY '24, you reset your tables and expectations for sales and operating performance. And so essentially just getting back from essentially almost a 0 payout to a 1.0 payout, we've added over -- about \$225 million of expense at the top end of our guidance just simply reflect like a normal payout for this year because it's really more of a year-over-year impact of not paying out anything and then maybe starting the year with the expectation that we would pay out at a more normal midpoint.

Joseph Isaac Feldman - *Telsey Advisory Group LLC - Senior MD, Assistant Director of Research & Senior Research Analyst*

Got it. That's helpful. And then a quick follow-up on the promotional side of things. I think, Corie, you had mentioned that there were some categories that were a little more promotional than expected. I was kind of curious as to what those were? And the sort of second part of promotions, are people responding when promotions do kick in?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Sure. I think -- I'll start and Corie can jump in. There are a few categories that we saw a heightened level of promotionality, appliances is one of them, computing was one of them, headphones is another. There's a number that more promotional year-over-year and in some cases, even more promotional than they were pre-pandemic. And like any year, that's not just us who are incented to drive sales. Our vendors are incented to drive sales as well. and the outcome of that actually didn't lead to strengthen our product margins in totality. So the more heightened promotionality didn't necessarily manifest in profitability pressure on a year-over-year basis, but there were a number of categories that people are trying to stimulate and drive sales because of the environment we're in.

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

From an elasticity perspective, Joe, I hate always feeling like I answer this way, it depends on the category a little bit. I think, to Matt's point about appliances, that definitely, right now, is a category that is a little bit more reflecting a duress customer or someone who needs to replace an appliance versus the more aspirational customer. In that world, you have a little bit less elasticity, you can imagine because you're not going to really respond to promotions as much.

Some of the other parts of the business that Matt mentioned around particularly things like home theater, we're seeing response when there's more promotionality and more value. And I think, overarchingly, what I -- from a consumer perspective, this is absolutely a consumer who's looking for value and will respond to some extent, but it can depend a bit on the category that we're talking about and what their state of mind is in terms of how aspirational they want to be within that category.

Operator

Your next question comes from the line of Anthony Chukumba from Loop Capital.

Anthony Chinonye Chukumba - *Loop Capital Markets LLC, Research Division - MD*

I was just wondering if you could just give a little bit more color on the Services business. You had a pretty strong comp increase in the Domestic business, but then in the International business, it was down. And I know part of that had to do with compares, but I was just wondering if you can just give us a little more color in terms of the divergence there.

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Yes, sure, Anthony. The -- on the Domestic side, the services revenue growth is attributable to the growth in total tech members from this point to last year. And so as we continue to sign up members, we continue to have more revenue come through that. And that's essentially the growth in the services category on the Domestic side.

On the International side, we did say that there is some gross profit rate pressure on Services. They're doing similar membership changes in Canada, and that's simply a reflection of timing of those membership changes they made last year. This year, they start to cycle those changes they made earlier in their year after this Q1. So that is a reflection of some of the membership changes that they're also making, not the same, but similar to what the domestic side is doing.

Operator

Your next question comes from the line of Mike Baker from D.A. Davidson.

Michael Allen Baker - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

I just wanted to follow up on a membership question. And so you're making some changes, which presumably is based on driving better profitability, yet the guidance for the profitability impact this year is unchanged, maybe that's just timing because it takes time to implement these changes. But what does this do to the long-term outlook in terms of the profitability on the membership business?

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

Maybe I'll start and then Matt can add. We went into the year, Mike, knowing we were going to make changes to our membership program. We have the most clarity around My Best Buy, the free program, and those changes we actually put in place at the beginning of the fiscal year. But we

also had an aspiration to make changes to the other side of the program. And this just gave us a little bit of time to -- before we announce the formal changes, but we had baked the assumption that we would get these changes into the guide for the year.

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Yes. So very specifically, we -- last quarter and this quarter, we've said that the gross profit rate, about 40 to 70 basis points of increase this year, one of those reasons is the changes to the membership program, part of which is the My Best Buy changes, as Corie mentioned, and then just expected changes on the other parts of the membership program.

And to your last part of your question, we would expect to continue to iterate and update the membership financials and expect to see probably continued profit rate expansion as you look into next year. Obviously, as you -- we still have Totaltech members that still have 2 years of benefits, and we'll have to honor those for that 2 years. And then as you get into the back half of this year, we will we'll start to see the benefit of the changes more. And then get into next year, we would continue to iterate and have to see it more upside.

Michael Allen Baker - *D.A. Davidson & Co., Research Division - MD & Senior Research Analyst*

Got it. Well, someone took advantage of the free installation, I'll miss that, but I'll take my \$20 savings on the annual fee.

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

Well, we promised that there will still be great deals on installation. And we made clear that we're still going to pull some of those great deals. So you will still see those coming. Also, please don't get too upset yet. And the other thing I just want to add, Mike, before you go is absolutely part of the changes result in impact to profitability. The intent of the changes was to understand customer behavior and then adjust the membership program based on the customer behavior we were seeing.

So in a world where you used to historically value points, but now things like free, reliable, fast shipping matter a lot more, you make that adjustment, not just because it has profitability impacts, but because you're actually learning about what your customers value and what accomplishes what you set out to do, which is to have more sticky customer relations relationships, increase that frequency and increase that share of wallet. So we're really trying to balance both sides of the equation as we're making these decisions.

Operator

Your next question comes from the line of Chris Horvers from JPMorgan.

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

Two related questions. So you talked about the midpoint for the year on the sales side, but you didn't comment on the operating margin range. And you did just materially beat your sort of gross -- what you talked about for the gross margin in the first quarter here. So are you expecting some give back? Any comments on that range?

And then, Corie, you mentioned preparing for a number of different scenarios, I guess, what does that mean? You have cut a lot of expense out of the business on the labor side. That's your biggest cost. It's still inflationary, where you see the opportunity to sort of protect the bottom line if comps do come in worse than expected?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Yes, I'll start, and Corie can jump in. Thanks, Chris. The -- in terms of the EBIT midpoint, we did not comment on that. I think there's more moving pieces within the EBIT level between gross margins and SG&A levers that we can pull depending on where the sales trends go. The largest factor in that equation is going to be gross profit rate. And we're obviously reflecting a range of 40 to 70 basis points. And so in terms of where we land, we have a little bit more drivers or levers we can pull to kind of maneuver through that range.

I think, in terms of the flow-through, we didn't flow through the Q1 our EBIT. It's more a function of us giving us just a little bit of room to navigate the remainder of the year. We obviously have a wide range of outcomes for the year, and we want to just make sure we're being prudent with how we're making decisions as we get towards the more meaningful back half of the year.

Operator

Your next question comes from the line of Peter Keith from Piper Sandler.

Peter Jacob Keith - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

I wanted to just talk about the sales trend from the last couple of months in the context of the overall retail landscape. So you did talk about a bit of a softening through the quarter, although I think February, of the last conference call, you were roughly down 10%. So it didn't seem like there was too much softening.

At the same time, retail has seen a significant weakness in big-ticket discretionary. You would think consumer electronics would be impacted by that. So your sales can be down, but not falling off a cliff. Maybe comment on what you're seeing within your business versus what you think is happening more broadly at retail?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Sure. I can start talking about the cadence of the quarter and then Corie can jump in about broader retail. Similar to the retail industry, we did see our sales sequentially get worse as the quarter progressed. February was the best performing month that we come in a little bit better than our -- the guidance we gave as we started the quarter, but there are a few reasons for that.

I mean we gave growth number, not a comp number, so there's a bit of difference between the growth number and the comp number. We always have a few closing the book entry. So comps in the quarter did sequentially get worse. We have, as we indicated, starting the quarter in line with the range that we gave for the first -- for the full quarter Q2, so therefore, improving from April into May in terms of comp. And so we feel good about that range we gave for Q2 at the moment.

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

As it relates to the consumer, Peter, I think we've been pretty consistent since really starting in Q1 of last year, saying, we felt like, to your point exactly, in big ticket discretion and specifically in CE, given especially how much demand we saw through the pandemic, the consumer was going to make trade-off decisions. And it's a consumer that clearly, when they're faced with record high inflation versus 2020 in food, housing and fuel, that's going to drive those trade-off decisions.

And I think what we've been anchored on is making sure we provide the best possible value and even altering and changing the membership program to make sure we're meeting that consumer where they are. And what we can see, I mean, we've always said, it's really hard to measure share in our business, right, because especially when it comes to services and new categories, it's very difficult.

But what we believe is we're at least maintaining share in the industry. And so, to your point, it's an industry where the consumer is making decisions, but it's also an industry where everyone needs the stuff that we've got. It's not like these are just want-to-have products they're need-to-have products.

And we -- especially as we look at those innovation cycles coming up, we can start to see this will stimulate a replacement and innovation cycle. So for right now, I feel really good about what we're trying to do to stay with the customer where they are given the trade-off decisions that they're making. And this industry is quite different than some of the others. And I think we've been pretty consistently trying to articulate what we're seeing in our consumers, and therefore, addressing their needs appropriately.

Operator

Your next question comes from the line of Jonathan Matuszewski from Jefferies.

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

Mine is on your B2B channel or Best Buy business, our checks would suggest you've had some pretty big wins on this side of the enterprise as of late. Curious if you could just update us on that channel, Corie.

Where is it tracking in terms of sales penetration? Is recent progress reflective of maybe any investments you've been making on that side of the business? And how are you thinking about this business performing in 2023 and beyond?

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

I am incredibly proud of what our direct team has been able to accomplish, frankly, throughout the pandemic. And we haven't specifically released this as like a separate segment of the business or sized it, but it's material and its growth, in general, has been outpacing what we've been seeing in the core.

And I think it's a really creative approach to everything from education, which relies highly on technology, to hospitality, which relies heavily on technology, to even agreements with sports teams and facilities where any of us know, as you walk around, there are a ton of technology experiences that are available. We continue to believe this is an interesting growth channel for us, and we even talked last time on the call a little bit about our appliance business and starting to work with homebuilders directly in a small pilot that we're doing.

So there's lots of different ways we're starting to and continuing. This has been a business for us for a long time. I think from an investment standpoint, I'm again very proud of the team has pivoted to even more of a digital experience. So if you go online and you're trying to buy at large quantity, we will basically move you into digitally the right channels to get you to the right people who can help you make more of those scaled purchases that you're looking for.

So we're finding lots of digital ways to understand our customers, and therefore, target them more as potentially small business owners versus the kind of targeting we would do for a normal customer. And so I like -- the team is doing a very nice job creating all the capabilities a little bit behind the scenes, frankly, in serving these business customers, and I'm proud of the growth that we've seen in that part of the business.

Operator

Your next question comes from the line of Brian Nagel from Oppenheimer.

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

So my first question, I guess, is a bit of a follow-up to some of the questions. But clearly, you managed very, very well a difficult environment here in Q1, a challenged sales quarter. In response to other questions, you said that, I think I heard it correctly in the business, actually deteriorate as the quarter progressed. So as you look at the business now and the performance or the activity of your consumers, what gives you the greatest confidence that this is the bottom? And as we look towards '24, '25, that we'll begin -- we'll see this rebound to more normalized growth at Best Buy or within the sector.

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

I think when we talk about the confidence we have, I think it is both relative to the backdrop of the performance we've seen, which was a pullback in demand last year and again projecting an ongoing pullback in demand this year. So a little bit different than some of the other industries. We started to see the change in consumer behavior much earlier than others. And as soon as -- as early as last year in Q1, we talked about it, we started to see that pullback in demand. So we're going to have now 2 consecutive years, as we talked about, of a consumer who's making some choices away from consumer electronics.

The nature of the industry is really what gives us the most confidence, and then obviously, our very stable position within it. The nature of the industry, this is an industry where technology is necessary, necessary to live our lives every think about the quantity of pieces of technology you touch in any given day, and that technology is not static. If you think about how quickly both the hardware and then if you think about what I will call air-clothes of software, things like generative AI or like VR and AR, how much that is changing, that will all drive form, feature changes in the product, which is part of what underlies our confidence at some point people want to. And we know this based on lots of history through recessions, through lots of different types of industry performance. People will upgrade and want to replace their equipment and their consumer electronics.

And so I think what gives us confidence is understanding that there is a very large vendor community out there that is very interested in continuing to stimulate demand, continuing to create really cool solutions for our customers. And that, over time, I don't see a world where we rely less on technology. And so that -- it is all those underpinnings that are giving us confidence as we head out of this year and into next year.

Now we said that, and I'll repeat it, that is based on what we can today. It's based on the environment as we understand it today. So of course, we're going to continue to monitor and see how consumers navigate what is obviously a very volatile environment, but that underpinning of how different this industry is versus any others in terms of both need and constant innovation, that is the biggest part that underscores, and then obviously, our position within it and how confident we feel in our partnership with our vendors, that is what gives us the confidence as we head into next year.

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

That's very helpful, Corie. And then if I could just ask a quick follow-up on related. So a lot of talk about membership and some of the shifts you're making there with the program. So I guess as we step back, clearly, Best Buy, there's a revenue piece of the membership program. How do customers that are members of Best Buy, how do they perform versus nonmember customers from just from an overall sales perspective?

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

Yes. We hit out a little bit in the prepared remarks, but they remain more engaged customers. They tend to spend more, they tend to shop across categories, they tend -- on the whole, so I'm just going to talk about this big kind of lump of members.

They tend to be our most engaged customers. Now what a couple of years of paid membership has given us though is a lot of data around what is it customers distinctly value because there's really 3 things you're trying to do with any membership program. You're trying to acquire customers, you're trying to retain customers and you're constantly trying to engage customers. Acquisition, retention and engagement are the cornerstones of any membership program.

And so, Brian, what we've been spending time on is not just who are we acquiring, but do they stay engaged with the program, are we retaining them? And so it's not just about kind of the full, here's what we see in our customers. They're for sure, more engaged and they're having better experiences. But now we can start to kind of bifurcate that large customer base into different need states. And we definitely see a customer who's really oriented around value and convenience. And we definitely see a customer who's really oriented around more fulsome service and support.

And this gives us the opportunity, given all the now very rich customer data we have, to start to target each of those kind of populations of customers based on a more tailored offering that we believe will resonate with them.

Operator

And your next question comes from the line of Seth Basham from Wedbush Securities.

Seth Mckain Basham - Wedbush Securities Inc., Research Division - MD of Equity Research

My question is around store labor. You guys have made a lot of changes to the labor model over the last year and you're continuing to iterate, I'd like to get a sense from you as to what you think the status is of morale within the labor force? And then secondly, whether or not the lack of the specialized roles could impact customer service levels in a negative way?

Corie Sue Barry - Best Buy Co., Inc. - CEO & Director

Yes. I'm going to start with the second part of the question, I'll work my way backwards. There is still very specialized labor in our stores. And we are very proud of that, and we are working very hard to make sure that we retain and continue to develop that very specialized experience over time. I think what we're trying to do is make sure that we are most effectively matching our labor, some of which is specialized -- like any retailer, some of which is more kind of part-time and generalized in nature, that we are matching that specifically with how many and what type of people are coming into our stores and what it is that they need.

And so we have continued to obviously invest in wages. We were one of the first to go to a minimum \$15. Our hourly wages are up more than 25% versus pre-pandemic. We're overarchingly investing hundreds of millions of dollars in benefits, and also, importantly, investing in career development and culture, and then really doing a lot of work to make sure we are bringing our employees along as we make these changes, involving them in the decisions and really trying to make sure that they feel like they also have a voice.

And I think -- how do we measure that? Well, one way is obviously we're looking at turnover, and we're pretty constantly looking at turnover. And we believe our general approach is working. Our turnover remains very low versus retail averages. It's consistent year-over-year. It is incredibly low in some of the most key areas like our general managers, where our turnover is in the mid-single digits, even given everything that RGMs have gone through in the last 4 years in particular. And I think that is one of the indicators.

A second indicator, we continue to see a very high level of applications. Our applications have grown substantially year-over-year. So you're seeing people want to come into the business, which is a good sign because that means that GMs are pulling them into the business. And then third, you can imagine, we measure employee engagement. And we measure it very consistently. And not just at the high level, like here's the number. We're looking literally regionally, store-by-store, distribution center by distribution center how engaged are our employees and what can we do? How do we read those verbatims? How do we pull the themes?

So we are doing everything we can to create the most engaged workforce. So it is constant work. It is not easy for our employees to go through this level of constant change, and I am incredibly proud that so many are choosing to stay with us and continue to build this culture for the future.

Operator

And your final question comes from the line of Steven Forbes from Guggenheim Securities.

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

Maybe just a high-level question on ROIC. Curious if you could update us on your various initiatives, inclusive of space allocation utilization? And then where do you see ROIC stabilizing sort of as we work our way through this normalization period? I don't know if you could sort of reference a pre-COVID level, mid-20s? Any thoughts on where we sort of stabilize ROIC?

Matthew M. Bilunas - *Best Buy Co., Inc. - Executive VP & CFO*

Yes, sure. I think, at the highest level, our ROIC is impacted by the level of profitability that's flowing through that calculation. And I think where we're pointed is at continuing to make improvements in our operating model and our efficiency. As we've talked about, as we look into the next few years, we've said that we expect and want to continue to grow our operating income rate, at the same time, the industry will begin, we believe, turnaround, and we'll continue to grow in sales and our OI rate will continue to improve as we look forward or expected to.

With that happening, we'll be able to drive a better profitability and that ROIC will start to climb probably back up closer to where we were, but again, that's through a combination of the industry improving, our initiatives continuing to improve and creating efficiencies and optimization through our business.

Corie Sue Barry - *Best Buy Co., Inc. - CEO & Director*

I think we have a great history, I would argue, in optimizing ROIC and making those educated bets. I would use even our store footprint as an example, things like our experience stores or outlets. There's a reason that we are pursuing those with vigor. And you can imagine what we're seeing in terms of return on those investments is giving us a lot of confidence into the future. There're other places where we're still testing and trying to make sure we feel like that ROIC is in line.

So I think we're pointing to that continuing to drive that return for our investors. And with that, I think that was our last question. So thank you for joining us today. I hope that many of the investors for listening today will be able to join us for our Annual Shareholder Meeting, which will be held virtually on June 14. So thank you, and have a great day.

Operator

This concludes today's conference call. Thank you for your participation. You may now disconnect.

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