

November 28, 2008

# Home Depot (HD - \$23.55)

Ticker: HD Exchange: NYSE

Initiating Coverage with a **BUY** Rating

## Home is where the *profit* is...

### Investment Summary:

We are initiating coverage of Home Depot Inc. (HD) with a *BUY* recommendation. Home Depot shares closed on November 27, 2008 at a price of \$23.55 per share. Our analysis indicates a per-share value for HD of \$26.00, implying a projected return of 10.4% from current levels.

- Housing Market Turnaround in the Offing?**  
Metrics measuring new and existing home sales have recently shown signs of steadying and sales prices have shown early signs of recovering. A recovery will be critical for HD and will allow for a return to a more reasonable and historic earnings.
- Attractive Valuation at Current Prices**  
At these levels, and assuming an expected housing rebound occurs, Home Depot trades at a compelling price based on both discounted cash flow metrics as well as price multiples analytics.
- International Expansion Broadening HD's Reach**  
Although the U.S. still accounts for the majority of HD's sales, the company is expanding abroad at a reasonable pace, especially when compared to rival Lowe's. This should give the firm first-mover advantage in vital overseas markets and allow for continued growth over the mid-to-long term.

Rating: **BUY**

Price (Nov. 27, 2008): \$23.55

12 – 18 Month Price Target: \$26.00

52 – Week Range: \$17.05 – \$31.08

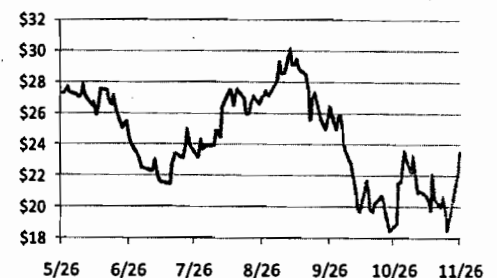
### EPS

2005:	\$2.26
2006:	\$2.63
2007:	\$2.55
2008 (est):	\$2.19
2009 (est):	\$2.17

### Relevant Ratios

P/E:	12.48
P/E (forward):	12.8
P/E (past 5 years):	20.5
EV/EBITDA (current):	7.84
EV/EBITDA (est):	7.25
ROE (ttm):	16.6
Dividend (annual):	0.90
Yield (%):	4.04
Shares Out. (bil):	1.69
Market Cap (bil):	39.99

### HD: 6-month chart



Source: Yahoo!Finance

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## 1. Investment Strategy

Investors today have a vast array of investment options at their disposal. Whether the decision relates to equity or fixed income investments, long or short strategies, or a short versus long-term time horizon, today's investor must clearly define their investment criteria and understand what products or strategies fit with these criteria. A variety of factors inter-relate to determine the desired strategy that the investor will ultimately follow. Often times, this decision revolves around the risk-return trade-off. Certain investors will choose to maximize potential returns by accepting more risky investment options, while other investors will choose to focus on maintaining a safe, less volatile allocation at the expense of possible above average returns. Another key factor in the investment decision relates to the investor life cycle theory. This theory states that investors will have different objectives depending on their stage in the investment life cycle. For example, until approximately their early thirties, investors are in the 'accumulation' phase and will/should follow more of a longer-term growth strategy. On the contrary, after retirement, the investor enters the 'spending and gifting' phases where capital appreciation is less of a priority and preservation of wealth becomes a focus (Reilly & Brown, 2006). Some of the main investment strategies are value investing, growth investing; large-cap focus, small-cap focus; and active and passive investing. Each strategy or focus has potential pros and cons, and any one may be suitable for investors depending on their individual circumstances and risk profile.

In determining our investment strategy, we are targeting this report's recommendation to investors of a similar demographic to that of the authors, and who are looking to add a security to an existing well-diversified portfolio. The targeted investor is in the accumulation phase of the investor life cycle, and therefore has a longer-term investment horizon. The investor's primary investment objective is capital appreciation, and they are prepared to accept somewhat more risk in order to achieve that potential return. With that being said, however, they are not looking for extreme day-to-day volatility to achieve this return. The equity security chosen for this report, Home Depot, Inc., is felt to meet the criteria

outlined for this hypothetical investor: A proven business model with a demonstrated history of growth, and a long-term strategy for continued success.

## 2. Country and Economic Conditions

The analysis of Home Depot's (HD) equity value begins by undertaking a top down analytical approach. Firstly, we will broadly analyze the North American economical landscape in order to identify various macro-economic factors which may influence our valuation. Next, we will focus on trends and indicators related specifically to Home Depot's industry; mainly, issues in the specialty retail and homebuilding sectors. Finally, the analysis will delve more deeply into company-specific issues with a thorough corporate analysis comprising both quantitative and qualitative aspects.

The economic environment throughout North America has deteriorated throughout the latter part of 2007 and 2008, caused mainly by issues emanating from the sub-prime housing crisis and tightening credit for consumers and businesses. Governments worldwide have been moving aggressively to shore-up corporate balance sheets and ensure that inter-bank lending continues. In October 2008, governments around the world enacted a coordinated interest rate cut in an attempt to steer the broader economy through the credit crisis with as little damage as possible. The Canadian and American central banks were key players in this action and it is likely that this dovish monetary policy will continue over the near term so long as serious macro-economic concerns remain. Additionally, large economic stimulus packages are being contemplated by governments worldwide in order to counteract continued job losses and prop up consumer and business spending (American Free Press, 2008).

Since the fourth quarter of 2007, average Canadian Gross Domestic Product growth has flat lined to near zero (0.1%), while U.S. GDP growth has fallen to approximately 1.3%. Economists generally see this low level of economic output for both countries continuing throughout the remainder of 2008, with a gradual turnaround occurring in early or mid-2009 as government actions to stabilize the markets takes effect. The American consumer, long resilient amidst economic turmoil, has begun to rein in spending,

with consumer spending statistics showing significant deterioration in September and October 2008. The unemployment rates in Canada and the U.S. will also likely continue to rise throughout 2009 as cuts in the financial (U.S) and manufacturing sectors (Canada) deepen. Having risen throughout early 2008 to near \$150 a barrel, the price of oil has since fallen sharply with the evolution of the global financial crisis and the market's concern over a prolonged economic downturn, to approximately \$50 a barrel. If this oil price level can be maintained, it will greatly benefit many aspects of the Canadian and American economies, and potentially shorten any downturn that is experienced. In addition to oil, other commodities (except gold) have seen steep price declines since early 2008. These declines could see a reversal in the upcoming quarters as the economic environment shows improvement. With the fall in oil and commodities has also come a correspondingly steep downturn in the value of the Canadian dollar vis-a-vis the U.S dollar. If maintained, this should breathe some new life into the export-driven Canadian manufacturing sector. Finally, inflation has risen substantial over the past several quarters, caused mainly by rising fuel and food costs. While oil has fallen from its recent highs, it is difficult to predict whether this will lead to a sustained easing of prices economy-wide; some economists recently have even raised the ominous possibility of widespread deflation.

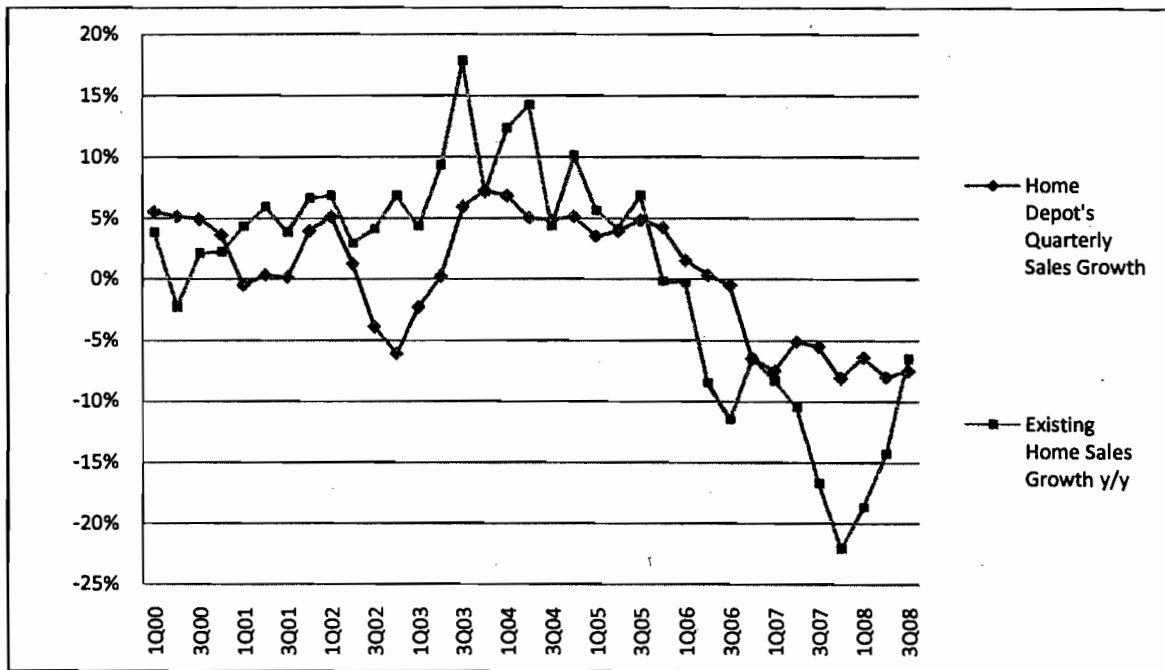
recent  
reversal  
this  
now

### 3. Housing Market Conditions

It is clear that the housing market, especially south of the border, is experiencing one of its worst downturns ever. Many American home buyers obtained mortgages that were beyond their means, or used mortgages that were structured in ways that made repayment problems likely to occur (such as interest-only mortgages). When economic conditions changed, mortgage defaults increased and caused a rash of home foreclosures. Now we are seeing most major housing-related statistical indicators showing several straight quarters of significant declines. U.S. housing starts have seen a consistent decline since 2006, and that trend isn't expected to be reversed until at least 2010. Home Depot's economic performance is invariably tied to these movements in housing statistics, as evidenced by

Figure 1, which illustrates the company's comparable-store sales growth as compared to U.S. existing home sales. The level of residential construction, a major component of the broader GDP calculation, has also been deteriorating since 2006 with substantial quarter-over-quarter and year-over-year declines. Again, most economists expect this trend to continue throughout at least 2009. Finally, new and existing home prices have fallen substantially from their highs of recent years, especially in what many saw as the 'bubble' markets of Florida and California. Here in Canada, most of these statistics, while not as dire, have still been quite weak and have shown little sign of reversing.

**Figure 1: Home Depot Sales Growth vs. U.S Existing Home Sales**



These housing indicators, as well as the other economic statistics listed above, present what is likely to be a depressed market for Home Depot in the near term. In difficult economic times with high unemployment, home repairs are often viewed as less of a priority. However, one may also look at this situation from another angle; because home sales have been on the decline and home buyers have been finding it more difficult to obtain credit for mortgages, people may be focusing less on new home purchases and more on home improvement projects, thus benefiting Home Depot. Additionally, while

the U.S. stock market (as measured by the S&P 500 index) is significantly off its 2007 high, equity markets in general are viewed as a forward-indicator and there comes a point where the economic and environmental risks become priced into equity markets and the risk-reward equation tilts in favour of equity ownership. We feel we are approaching this time in the U.S. equity markets.

#### 4. Sector and Structure of Market

The home improvement retail market is a very large and competitive market, especially in the current economic environment. This industry would traditionally be considered relatively stable; however, it is very dependent on economic conditions, and in particular the housing market. The current housing market has wreaked havoc upon the industry, as a large portion of sales are driven by housing starts and repairs, even though many of the competitors within the industry sell much more than just home improvement supplies. This industry is also highly affected by seasonal cycles and natural events or disasters. For example, in 2008, Hurricanes Gustav and Ike boosted Home Depot sales in the third quarter of 2008 by approximately \$125 million, but profits were wiped out because those sales were low-margin sales, and additional expenses were incurred including freight, store repair, and other associated costs (Home Depot, 2008). It has been very difficult for any major player in this industry to succeed in the current economic downturn because people are tending to rein in spending <sup>rather</sup> ~~versus~~ <sub>than</sub> purchasing new goods, and housing starts are at an all-time low (CBC, 2008). The industry is very fragmented and many of the competitors to the major retailers are simply neighbourhood hardware stores. Therefore, a main objective of the major industry players is to deliver a wide assortment of products, while still offering excellent customer service as would be found at a smaller retailer. ✓

A Porter's Analysis of the home improvement retail industry indicates that it is moderately attractive for incumbents and relatively unattractive for new entrants. Rivalry is high given that there are several major retailers as well many small operations in cities across North America. Suppliers essentially have the ability to be price setters and therefore have power, putting the retailers at a disadvantage.

Although buyers do not have a large ability to change prices drastically, their power is also high given that there are no incremental costs to switching to different retailers and most customers generally shop around at their local stores to find the best deal, unless they are commercial customers and get a discount with a certain retailer. The threat of entrants should be considered moderate, because although it is relatively easy for anyone to set up a small hardware operation, to compete at the scale that Home Depot and Lowe's does is very capital and knowledge intensive. Finally, the threat of substitutes should be considered moderate because there are several products that home improvement retailers provide that can be found at other retail stores such as Wal-Mart. However, there are many products, including lumber, many home improvement products, and upscale tools that can only be found at true hardware stores or home improvement retailers.

Home Depot is one of the world's largest home improvement retailers and is the second largest in the United States, based on net sales for 2007. Since Home Depot sells such a large assortment of products and services, they have many significant competitors that would normally not be thought of as key players in the home improvement retail industry such as Wal-Mart, K-Mart, and Sears. Given that Home Depot also sells to a variety of customers (do-it-yourself (DIY) customers, do-it-for-me (DIFM) customers, and professional contractors), the company's competitors range from neighbourhood hardware stores, to major corporations such as Best Buy, Amazon, Canadian Tire, and Costco (Datamonitor, 2008). It is clear, however, that Home Depot's most significant and direct competitor is Lowe's Companies Inc.

Home Depot's third quarter sales were \$17.8 billion, a 6.2% decrease from Q3 2007, for a year to date sales of approximately \$39 billion (Home Depot 3Q Conference Call, 2008). Earnings per share were \$0.45 versus consensus estimates of \$0.38, indicating that even throughout this economic turmoil, Home Depot is still able to outperform.

Home Depot added 11 new stores during the third quarter of 2008, for a total store count of 2,268 worldwide. This represented a total of 238 million selling square feet, an increase of 2.1% over the previous year. 11% of firm's 257 total stores operate in Mexico, China, or Canada.

**Figure 2: LOW vs. HD key Statistical Comparison**

	Home Depot	Lowe's
<b>2008 Sales to Date</b>	\$38.79 B	\$38.2 B
<b>Sales/square foot</b>	\$238/M	\$214/M
<b>Return on Equity</b>	16.6%	14.4%

Source: Yahoo Finance and HD Annual Reports

### **Lowe's Companies Inc.**

Lowe's Companies (Lowe's) is the second largest home improvement retailer in the world and is based out of the United States. Lowe's offers home decorating, maintenance, repair, and remodeling products and services for regular customers to commercial contractors. Lowe's operates both 117,000 square foot stores in large markets and 94,000 square foot stores in smaller markets, for a total of 1,577 stores in the United States and Canada and a total of 179 million square selling feet (Lowe's Corporation, 2008).

Lowe's regularly stocks approximately 40,000 SKUs, but has hundreds of thousands of products available through their special order system. The company carries a selection of products from major brand names including Whirlpool, Kitchen Aid, Samsung, Pella, Werner, Kohler, DeWalt, John Deere, and many more. Lowe's also carries a large number of exclusive brands in order to provide both regular and premium products in the paint, lighting, flooring, doors, windows, tools, and other home improvement product segments. Similarly to Home Depot, Lowe's targets the complete range of customers, from DIY to commercial business customers. Lowe's owns and operates 11 regional distribution centres that are

located strategically across the US, and each regional distribution centre serves approximately 126 stores. Additionally, the company operates 13 flatbed distribution centres for lumber and building commodities and 4 facilities to manage special order sales, import business, and internet orders. Lowe's purchases its products from approximately 7000 vendors around the world with no single vendor providing more than 5% of total purchases (Datamonitor, 2007).

## 5. Home Depot Corporate Profile

### *History*

Home Depot was founded in 1978 by Bernie Marcus and Arthur Blank, and they opened their first two Home Depot stores in Atlanta, Georgia the following year. The two entrepreneurs had the unique vision to open a one-stop-shop for the home improvement consumer. From the beginning, Home Depot stores were designed with size in mind; they measured north of 60,000 square feet and stocked approximately 25,000 SKU's (Home Depot, 2008). Home Depot was the fastest growing retailer in American history (averaging 119% sales growth through 1997), and went public in 1981. The company opened its 100<sup>th</sup> store in 1989, entered Canada in 1994, Mexico in 2001, and China in 2006 (Home Depot, 2008).

*Need more details*

### *Profile*

Home Depot is a large Atlanta-based retailer operating mainly in the United States, but also in other parts of the world. The company is the largest home improvement retailer in the United States, ahead of rival Lowe's, and is the second largest general retailer in the U.S., behind only Wal-Mart (Schulz, 2008). Home Depot stores sell a variety of building supplies, appliances, lawn care and other home improvement products to do-it-yourself customers, trades people and contractors. The company's advertising uses the slogan "You can do it, we can help". (Yahoo! Finance, 2008).

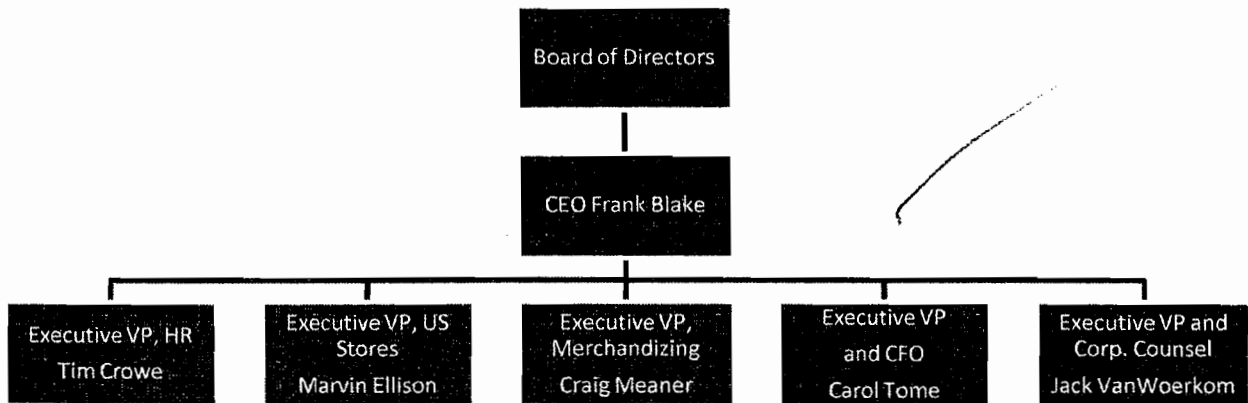
### *Corporate Management*

An overview of Home Depot's executive team is presented in Figure 3. Since January of this year, Home Depot's Chief Executive Officer has been Frank Blake. Mr. Blake has been with the company since 2002 and prior to his promotion, was the Vice President of business Development and Corporate Operations.

Upon the announcement of his appointment, many questioned Mr. Blake's fit for the CEO role as he had never before led a company, had no retail experience, and is a lawyer by training (Gogoi, 2008). Mr. Blake has had little opportunity for on-the-job training since his appointment with the housing market downturn and corresponding fall in the company's share price. Prior to Mr. Blake's appointment, Home Depot's CEO was Robert Nardelli. Nardelli was Chief Executive at HD from 2000 to 2007 and was credited by many for doubling the company's sales and improving the firm's competitive position. However, Nardelli was widely criticized in the media for his \$210 million severance package when he was reportedly ousted by the board in 2007.

Below Mr. Blake serve several experienced Executive Vice Presidents: HD Chief Financial Officer and Executive Vice President since 2001 is Carol B. Tome; Tim Crowe is Executive VP for Human Resources; Marvin Ellison is Executive VP for U.S. Stores; Craig Meaner is Executive VP for Merchandizing; and Jack A. VanWoerkom is Executive VP and Corporate Counsel (Home Depot, 2008).

**Figure3: Home Depot Executive Team**



Source: Home Depot web site (2008)

**Corporate Strategy**

Home Depot's main strategy is to focus on the retail business, invest in the right people, improve its stores, provide great products at great value, drive a high return on invested capital, and return excess cash to shareholders (Home Depot, 2007).

Through the sale of subsidiary HD Supply in August 2007, Home Depot management has clearly redefined the company as a retail business. They have also redefined the capital allocation strategy by focusing on improving the return on invested capital (ROIC) and comparing all uses of excess cash to the value created for shareholders through share repurchase programs. To show this, management used the proceeds from the sale of HD Supply to repurchase \$10.7 billion in stock shortly after the sale was complete; a buy-back that put them approximately halfway through the previously announced \$22.5 billion recapitalization plan. Management plans to maintain an adjusted debt/EDITDA ratio of 2.5 times and a payout ratio of 30%, among the highest in the retail business (Home Depot, 2007).

In order to deal with the current economic downturn, management has plans to open fewer stores than they have historically, and to focus more on improving existing stores. As part of Home Depot's continuing investment plan, they have aggressive plans to build on the US supply chain and to put many more associates on the floor through a major "aprons on the floor" initiative. They have also taken the first step in transforming the company's IT infrastructure by converting the Canadian business to an ERP platform that focuses on improving merchandising activities. Management is confident that as the housing market improves, they will see greater operating leverage and look forward to returning to double digit operating margins over the next several years (Datamonitor, 2008). A brief SWOT analysis can be found in **Figure 4** that illustrates Home Depot's positioning in the industry.

Figure 4: Home Depot SWOT Analysis

Strengths	Weaknesses
<ul style="list-style-type: none"> <li>• Strong market position</li> <li>• Excellent supplier relationships</li> </ul>	<ul style="list-style-type: none"> <li>• Sub optimal capital structure; <i>very</i> debt-heavy <i>load</i></li> <li>• Recent product recall issues</li> </ul>
Opportunities	Threats
<ul style="list-style-type: none"> <li>• Strong international presence; first-mover advantage in China</li> <li>• Power tool market is expanding</li> <li>• Online sales growth</li> </ul>	<ul style="list-style-type: none"> <li>• Intense domestic and international competition</li> <li>• Slowing U.S. housing market</li> <li>• Significant overall economic downturn</li> <li>• Upward pressure on U.S. wages</li> </ul>

Source: Datamonitor; Cockeram, Fraser & Co. Analysis

## 6. Historical Financial Performance and Ratios

Analysis of Home Depot's historical financial ratios indicates that they are a strong company that has nonetheless been highly affected by the current housing market and economic downturn. The historical financial data has been analysed in four main areas; profitability, liquidity, debt management, and asset management (Figure 5).

Home Depot has historically provided excellent returns for its shareholders; over the long term, earnings per share have grown at a consistent pace. Return on equity increased gradually from 18.5% in 2002 to 22.9% in 2005, before a slight and gradual decrease to 20.5% over the 2006 and 2007 period. This decrease is likely attributable to a turn in the housing market at that time, leading to the current crisis we are currently witnessing. EBITDA to revenue shows a similar trend in recent returns. Similarly, the company has seen a gradual, yet significant, decrease in pre-tax and net profit margins from 2005 to 2007. Pre-tax margin decreased by 2.8% over the two years, while net profit margin decreased by 1.5%.

**Figure 5: Home Depot Historical Ratio Analysis**

Home Depot, Inc.	2002	2003	2004	2005	2006	2007
<b>Profitability Analysis</b>						
Return on Equity (%)	18.50	20.39	21.48	22.86	22.18	20.56
EBITDA of Revenue (%)	11.56	12.22	12.65	13.42	12.72	11.83
Pre-Tax Margin	10.08	10.56	10.82	11.39	10.25	8.56
Net Profit Margin (%)	6.29	6.64	6.84	7.16	6.34	5.68
Effective Tax rate (%)	37.60	37.10	36.79	37.10	38.11	36.40
<b>Liquidity Indicators</b>						
Quick Ratio	0.41	0.41	0.35	0.25	0.30	0.14
Current Ratio	1.48	1.40	1.37	1.19	1.39	1.15
Working Capital/Total Assets	0.13	0.11	0.10	0.05	0.10	0.04
<b>Debt Management</b>						
Current Liabilities/Equity	0.41	0.43	0.43	0.48	0.52	0.72
Total Debt to Equity	0.07	0.06	0.09	0.15	0.47	0.76
Long-Term Debt to Assets	0.04	0.02	0.06	0.06	0.22	0.26
Interest Coverage	159.70	111.37	114.03	65.91	24.74	11.04
<b>Asset Management</b>						
Revenues/Total Assets	1.94	1.88	1.87	1.83	1.74	1.75
Revenues/Working Capital	15.00	17.17	19.14	33.34	17.92	39.30

*Source: Home Depot Annual Reports*

The current economic downturn has also had an effect on Home Depot's traditionally strong balance sheet. Home Depot has seen its current ratio decrease from 1.39 to 1.15 between 2006 and 2007. Within this current asset category, the firm holds a large amount of inventory, resulting in a quick ratio of only 0.14. The company's inventory makes up approximately 90% of its current ratio, which in this market could be a problem if Home Depot was forced to liquidate its assets to pay its liabilities. It is unlikely however that they would be forced to do so, as it can be assumed that the company's suppliers know that the company is simply going through a rough period and should return to their original position once the housing market strengthens. HD has also seen a decrease in working capital to total assets, dropping to a six year low of 4%. We are, however, confident that this drop in liquidity is due to

the current housing crisis and that Home Depot is committed to returning its balance sheet to its previous strength when the housing crisis ceases, around 2010.

It is very clear that Home Depot has had to drastically increase its reliance on liabilities and debt since the start of the housing crisis. Current liabilities to equity were very stable between 2002 and 2004, but have seen an increase from 0.48 to 0.72 between 2005 and 2007. Similarly, total debt to equity and long term debt to assets have increase from 15% to 76% and 6% to 26% respectively, from 2005 to 2007. Home Depot is less able to cover their long-term debt interest payments, as indicated by the drop in the interest coverage ratio from approximately 114 times to just over 11 times from 2004 to 2007. Again, the current economic downturn has clearly hit Home Depot hard, and increased their requirement for debt to service their assets and general business expenses.

Finally, Home Depot saw a slight decrease in revenue to total assets from 2002 to 2005, followed by a more drastic drop from 1.83 to 1.74 in 2006, remaining stable at 1.75 in 2007. The company had also been realizing a gradual increase in revenues to working capital from 2002 to 2004, but then saw a large increase followed by a large drop and another large increase in 2007. The volatility from 2005 to 2007 was caused by an uncharacteristically drastic change in working capital in 2006 followed by a large drop in 2007, with gradually decreasing revenues over the two years.

#### **7. Forecasted Performance EPS**

Our revenue model for Home Depot is highly dependent on our growth assumptions going forward for fiscal 2008 to fiscal 2012. It is therefore very important to develop a realistic growth schedule that reflects how Home Depot will be affected by the current economic downturn and housing crisis, and how the company will move forward once the markets return to a more normal pattern of growth.

Each quarter during fiscal 2008 has shown sales deterioration year-over-year. The third quarter of 2008, for example, was down 6.2% from the same period in 2007, with similar results in Q1 and Q2. We foresee similar results for the remainder of 2008 as Home Depot will continue to be negatively affected

by the housing crisis in the US, and the fourth quarter has historically not been Home Depot's strongest quarter; therefore, we predict overall growth of negative 6% for F2008. Although the Canadian division has been slightly less affected, the majority of Home Depot's sales come from the US, so it will be difficult for the company to see positive growth until the housing market there improves. We also predict sales growth of negative 1% for fiscal 2009, representing a gradual return to positive growth in 2010, when the housing markets are expected to turn around.

**Figure 6: 2008E Quarterly Revenue Model**

<u>Home Depot, Inc.</u>	<u>Q1 08</u>	<u>Q2 08</u>	<u>Q3 08</u>	<u>Q4 08E</u>
Net Sales	17,907	20,990	17,784	16,027
% change		17%	-15%	-10%

Once the housing markets turn, we expect that Home Depot will return to positive growth. We have conservatively predicted 3 % growth going forward post-2010 as no one, including us, can be exactly sure when we will come out of this economic downturn and whether or not people will return to their normal buying behavior.

**Figure 7: Annual Revenue Model for 2008E - 2012E.**

<u>Home Depot, Inc.</u>	<u>2008E</u>	<u>2009E</u>	<u>2010E</u>	<u>2011E</u>	<u>2012E</u>
Net Sales	72,708.06	71,980.98	74,140.41	76,364.62	78,655.56
% change	-6%	-1%	3%	3%	3%

### ***Profit & Loss Model***

Our assumptions for the profit and loss (P&L) model are just as critical to our earnings per share estimates as the revenue growth assumptions. To forecast our P&L model we assumed that many of the income statement accounts would remain as a steady percentage of sales, as they have historically. Certain line items, including depreciation expense and income taxes expense, for example, were kept at historical depreciation and income tax rates, respectively. Many of the P&L accounts increase

proportionately with sales; however, there are some items that we feel Home Depot will be able to improve going forward. For example, we have projected that SG&A expense as a percentage of sales will decrease by 50 basis points starting in 2010. Similarly, we project a 50 bp improvement in the COGS margin starting in 2011 as the company will be able to increase efficiency in selling expenses and COGS once the housing market has turned around and companies are generally able to increase efficiency due to learning curve effects. Again, we believe that we have been conservative in many of our estimates in order to provide a conservative and more accurate valuation of the company, considering the current economic situation it is facing. Home Depot has only seen earnings from discontinued operations once in the past 5 years, so we assume that they will base all of their earnings on continuing operations going forward. Similarly, we show both basic and fully diluted earnings, just in case all options become realized, showing the worst case scenario. Home Depot is in the middle of a share repurchase program, and has plans to eventually repurchase approximately \$12 billion more in stock. However, we do not foresee this happening until they have the funds to do so, so we have projected a decrease of 100 million shares per year starting in 2010.

**Figure 8** shows our projection of \$0.55 EPS for the fourth quarter of 2008, while **Figure 9** shows our expectation for a total of \$1.92 per fully diluted share for F2008, or a 19% decrease from F2007. However, starting in 2009, we expect EPS to return to double digit growth of 13%, 16%, 16%, and 10% in the following three years. This EPS growth is completely reflective of our model assumptions, which are based on our predictions of the housing market and economic crisis turnaround. Post-2012, we expected Home Depot to return to more stable growth of approximately 3.5% going forward.

Figure 8: 2008E Quarterly P&amp;L Model and Forecasted EPS

	Q1 08	Q2 08	Q3 08	Q4 08E
<b>Net Sales</b>	<b>17,907</b>	<b>20,990</b>	<b>17,784</b>	<b>16,027</b>
Cost of Sales	11,835	14,026	11,884	9,952
<b>Gross Profit</b>	<b>6,072</b>	<b>6,964</b>	<b>5,900</b>	<b>6,075</b>
S,G & A and Other	4,900	4,470	4,186	3,894
Depreciation and Amortization	444	452	391	537
<b>Operating profit - EBIT</b>	<b>728</b>	<b>2,042</b>	<b>1,323</b>	<b>1,645</b>
Interest expense	167	161	141	185
Interest and Investment Income	3	4	27	24
<b>Pretax income - EBT</b>	<b>564</b>	<b>1,885</b>	<b>1,209</b>	<b>1,483</b>
Provision for Income Taxes	208	683	453	558
<b>Earnings from Continuing Operations</b>	<b>356</b>	<b>1,202</b>	<b>756</b>	<b>925</b>
<b>Earnings from Discontinued Operations, net of tax</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Net Income</b>	<b>356</b>	<b>1,202</b>	<b>756</b>	<b>925</b>
Common dividends	378	378	378	(394)
Payout ratio	106%	31%	50%	(2)
Pro Forma EBITDA Reconciliation				-
EBIT	728	2,042	1,323	2,372
Depreciation & amortization	444	452	391	537
<b>EBITDA</b>	<b>1,172</b>	<b>2,494</b>	<b>1,714</b>	<b>2,908</b>
Weighted Average Common Shares	1,679	1,680	1,680	1,680
Basic EPS from Continuing Operations	0.21	0.72	0.45	0.82
Basic EPS from Discontinued Operations	-	-	-	-
<b>Basic EPS</b>	<b>0.21</b>	<b>0.72</b>	<b>0.45</b>	<b>0.55</b>
Diluted Weighted Average Common Shares	1,683	1,685	1,685	1,685
Diluted EPS from Continuing Operations	0.21	0.71	0.45	0.81
Diluted EPS from Discontinued Operations	-	-	-	-
<b>Diluted EPS</b>	<b>0.21</b>	<b>0.71</b>	<b>0.45</b>	<b>0.55</b>

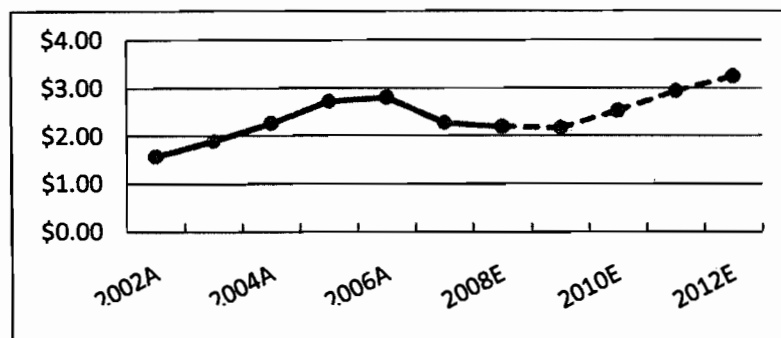
Source: Home Depot Quarterly Reports and Cockeram, Fraser & Co. Analysis

Figure 9: Annual P&amp;L Model &amp; EPS Forecast

Income Statement (amount in millions USD, except per share data)

	2007A	2008E	2009E	2010E	2011E	2012E
<b>Net Sales</b>	<b>\$77,349</b>	<b>\$72,708</b>	<b>\$71,981</b>	<b>\$74,140</b>	<b>\$76,365</b>	<b>\$78,656</b>
Cost of Sales	51,352	47,696	47,220	48,636	49,713	51,205
<b>Gross Profit</b>	<b>25,997</b>	<b>25,012</b>	<b>24,761</b>	<b>25,504</b>	<b>26,651</b>	<b>27,451</b>
S,G & A and Other	17,053	17,450	16,556	16,682	17,182	17,698
Depreciation and Amortization	1,702	1,824	1,805	1,859	1,915	1,973
<b>Operating profit - EBIT</b>	<b>7,242</b>	<b>5,738</b>	<b>6,401</b>	<b>6,963</b>	<b>7,554</b>	<b>7,781</b>
Interest expense	696	654	648	667	687	708
Interest and Investment Income	74	58	58	59	61	63
<b>Pretax Income - EBT</b>	<b>6,620</b>	<b>5,142</b>	<b>5,810</b>	<b>6,355</b>	<b>6,928</b>	<b>7,136</b>
Provision for Income Taxes	2,410	1,903	2,150	2,351	2,563	2,640
<b>Earnings from Continuing Operations</b>	<b>4,210</b>	<b>3,239</b>	<b>3,660</b>	<b>4,004</b>	<b>4,365</b>	<b>4,495</b>
<b>Earnings from Discontinued Operations, net of t:</b>	<b>185</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Net Income</b>	<b>4,395</b>	<b>3,239</b>	<b>3,660</b>	<b>4,004</b>	<b>4,365</b>	<b>4,495</b>
Common dividends	1,709	1,512	1,512	1,422	1,332	1,242
payout ratio	39%	47%	41%	36%	31%	28%
<b>Pro Forma EBITDA Reconciliation</b>	<b>7,242</b>	<b>5,738</b>	<b>6,401</b>	<b>6,963</b>	<b>7,554</b>	<b>7,781</b>
EBIT	1,906	1,824	1,805	1,859	1,915	1,973
Depreciation & amortization	9,148	7,562	8,206	8,823	9,469	9,753
<b>EBITDA</b>						
Weighted Average Common Shares	1,849	1,680	1,680	1,580	1,480	1,380
Basic EPS from Continuing Operations	2.28	1.93	2.18	2.53	2.95	3.26
Basic EPS from Discontinued Operations	0.10					
<b>Basic EPS</b>	<b>2.38</b>	<b>1.93</b>	<b>2.18</b>	<b>2.53</b>	<b>2.95</b>	<b>3.26</b>
% change	-15%	-19%	13%	16%	16%	10%
Diluted Weighted Average Common Shares	1,856	1,690	1,690	1,590	1,490	1,390
Diluted EPS from Continuing Operations	2.27	1.92	2.17	2.52	2.93	3.23
Diluted EPS from Discontinued Operations	0.10					
<b>Diluted EPS</b>	<b>2.37</b>	<b>1.92</b>	<b>2.17</b>	<b>2.52</b>	<b>2.93</b>	<b>3.23</b>
% change	-15%	-19%	13%	16%	16%	10%

Figure 10: Actual and expected HP EPS Performance



Source: Cockeram, Fraser &amp; Co. Analysis

## 8. Valuation

We have valued Home Depot common equity using the average of comparable P/E and EV/EBITDA multiples and a Discounted Cash Flow (DCF) Model.

### *P/E Comparable Analysis*

To value Home Depot using this method, it was necessary to find an average P/E ratio for the comparable companies within the industry. The only two truly comparable companies within the industry are Home Depot and Lowe's because other players are either private and do not disclose the appropriate information, or do not operate on the scale that these two companies do. **Figure 11** shows the P/E multiples for Lowe's and Home Depot (which are both surprisingly similar) for an average of approximately 12.5x.

**Figure 11: Home Depot and Lowe's P/E Multiples**

<u>Name</u>	<u>Ticker</u>	<u>Current Actual</u>	<u>2009E</u>
Home Depot, Inc.	HD	12.54	12.8
Lowe's Companies, Inc.	LOW	12.38	11.8
<b>Average</b>		<b>12.46</b>	<b>12.25</b>

Applying this average multiple of 12.5 times to our estimated 2009 EPS implies a target price of \$26.53.

According to this valuation, Home Depot is currently trading at a discount price.

### *EV/EDBITDA Comparable Multiple Valuation*

Applying the EV/EBITDA comparable analysis is similar to the P/E multiple process. By analyzing our estimated forecast for F2008, we have derived an estimated EV/EBITDA multiple of 7.25, which is slightly above that of Lowe's. By applying the average forward looking EV/EBITDA multiple and making adjustments for cash and debt levels, we have arrived at fair target price of \$25.78. **Figures 12 and 13** illustrate the components of the valuation process using the EV/EBITDA method.

Figure 12: Home Depot and Lowe's Forward Looking EV/EBITDA Multiples

Name	Ticker	2009E
Home Depot, Inc.	HD	7.25
Lowe's Companies, Inc.	LOW	6.25
<b>Average</b>		<b>6.75</b>

Figure 13: Home Depot EV/EBITDA Valuation target price for 2009E

HD, LOW average	6.75
HD EBITDA	8,206
Enterprise Value	55,391
Less: Total Debt	11,383
Plus: Cash	445
Equity Value	43,563
Shares O/S	1,690
<b>EV/EBITDA Target Price</b>	<b>\$ 25.78</b>

### DCF Valuation Analysis

The third portion of our valuation is based on our estimates for the company's future free cash flows.

The assumptions for our DCF model are as follows:

1. A risk-free rate of 3.67% based on current 90-day T-Bill rates
2. A Beta of 1.17 (As provided by Bloomberg)
3. A market risk premium of 7.66% (as provided by Bloomberg)
4. A WACC of 11.17% as given by the following
  - a. Weight of debt = 22.32%
  - b. Cost of debt = 4.90%
  - c. Weight of equity = 77.68%
  - d. Cost of equity = 13.12%
5. A perpetual growth rate of 3.75 after 2012
6. Current Diluted Shares outstanding of 1,690 million (as per Q3 Earnings Call)

Using the assumptions we have listed above, the free cash flow calculations that are shown in **Figure 14** below result in a DCF Valuation of \$25.96. This again shows that Home Depot is currently trading at a discount to its intrinsic and fair value per share.

**Figure 14: DCF Valuation Model for Home Depot Inc.**

	2008 E	2009 E	2010 E	2011 E	2012 E
EBIT	5,738	6,401	6,963	7,554	7,781
(+) Depreciation	1,824	1,805	1,859	1,915	1,973
Change In Net Working Capital					
Increase in Operating C.A.	(124)	(141)	419	431	444
(+ Increase in Operating C.L.	676	(113)	337	347	357
(-) Capital Expenditures	1,977	1,529	2,680	2,760	2,843
(-) Increase in Other Assets	(41)	(6)	17	18	18
(+) After-Tax Interest	412	408	420	433	446
(-) Cash Taxes	1,903	2,150	2,351	2,563	2,640
<b>Free Cash Flow</b>	<b>4,936</b>	<b>4,969</b>	<b>4,112</b>	<b>4,476</b>	<b>4,611</b>
<b>WACC Breakdown</b>	PV 4,449	4,038	3,013	2,956	2,745
WACC = 10.93%	NPV 17,201				
Equity	Terminal Value 39,662				
Weight = 77.68%	Discounted Value 56,863				
Cost = 12.66%	Add cash 445				
Beta = 1.17	Subtract debt 13430				
Rf=3.67					
Rp=7.66					
Debt	Implied Equity Value 43,878				
Weight = 22.32%					
Cost = 4.90%					
	<b>Equity Value per share \$25.96</b>				

### Valuation Summary

**Figure 15: Home Depot Valuation Summary**

Approach	Multiple	2009E	Implied Target Price
P/E	12.25x	2.17/sh.	\$26.53
EV/EBITDA	6.75x	7,562	\$25.78
DCF			\$25.96
<b>Average</b>			<b>\$26.09</b>

Based on the three valuation approaches described above, we have determined a 12-18 month target price of \$26 per share. The range of our valuation methods varied between a low of \$25.78 with the EV/EBITDA multiple method, to a high of \$26.53 using the comparable P/E method.

## 9. Risk Assessment

There are several important risk factors inherent in our valuation of Home Depot shares. These factors are discussed below and should be well understood prior to any investment decision.

**Continued Housing Market Instability:** Home Depot's future prospects are invariably tied quite closely to the U.S. housing market. While the American government has been using every tool at its disposal to rectify the troubles in the credit and housing markets, it is entirely possible that these remedies may not have the desired effects. If this is the case, the housing market downturn could be longer and deeper than we expect. Continued protraction in the housing market will negatively affect Home Depot's prospects going forward.

**Tight Credit Environment:** While the credit markets have shown signs of easing of late, corporate and consumer borrowing is still much more restricted than in the past. This situation could make for expensive borrowing for the company and reduced consumer spending.

**Domestic Market Approaching Maturity:** Home Depot has long traded at a premium multiple to the broader market because of its solid growth prospects in the prosperous American market. The company's consistent growth has resulted in a store base approaching saturation. While continued overseas growth is encouraging, slowing domestic growth could put pressure on Home Depot's multiple in the future.

**Gross Margin Contraction:** While competing aggressively with Lowe's over the past several years, Home Depot has been able to maintain relatively stable gross margins. The company recently announced broad discounts across a wide cross-section of products, with the goal of gaining market share. If this discounting results in more aggressive pricing on the part of Lowe's, gross margins could be depressed over a longer period, likely resulting in pressure on Home Depot's shares.

**Supply Chain Overhaul:** As part of Home Depot's strategy to combat Lowe's, the company is undertaking an overhaul of all aspects of their supply chain. If done successfully, this revamp should

allow for expanded gross margins in future years. This refurbishment, however, is massive in scale and it is possible that the process will not proceed as smoothly, or as quickly, as expected.

#### 10. Investment Recommendation

Based on our calculated 12 – 18 month target price of \$26.00 per share, we are placing a BUY rating on Home Depot's common equity. While it is clear that this is one of the most challenging environments ever for home improvement retailers, we feel that the pain in the housing markets is nearing an end, the equity markets are approaching (if not at) a bottom, and the company will be able to emerge from this slump as a stronger and better positioned firm. At the stock's current price of approximately \$23.50 per share, our analysis indicates a possible 10.4% upside from current levels. The stock is trading significantly above its recent lows near the \$17 range therefore we feel the broader market is now realizing the value in this name and the potential it offers investors going forward. In summary, for the long-term, growth oriented investor we are targeting with this analysis (as discussed in the 'Investment Strategy' section), we believe Home Depot should be a top pick.

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