



Lowe's & Home Depot

Comparative Financial Analysis and Valuation

Jason Stevens & Megan Taylor

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Introduction and Objectives

The objective of this paper is to do a thorough analysis of two large, publicly traded companies and determine based on that analysis where we, as investors, would like to invest three million dollars. The companies we chose for our analysis are Lowe's Company Inc. (Lowe's) and The Home Depot, Inc. (Home Depot).

In this analysis, we will look at the industry or industries in which Lowe's and Home Depot operate, the drivers of those industries, and how those drivers affect the companies and their strategies. We will also explore the history of each company, and their individual corporate strategies. We will then do a side-by-side comparison of the companies' financial health, looking at common metrics such as their return on assets, their profit margins, and their debt-to-equity ratios.

We will also take a look at the risks facing the two companies, generally as well as specifically. In the last step before we discuss our conclusion, we will look at the Standard and Poor's (S&P) Ratings for the two companies, as well as what other analysts have to say about the prospects for the firms.

Comparability

Lowe's and Home Depot are comparable because they both operate primarily in the same industry, Home Improvement Stores in the US. (Phillips, 2014) The companies are of similar size, although Home Depot is slightly larger, as evidenced by the revenues generated. Both are public companies listed on the Fortune 500.

Industry Drivers and their Effect on the Companies

The Home Improvement Stores Industry (HISI) encompasses a large number of product offerings, which overlap with the offerings of similar industries segregated into the following discrete sub-industries: Lumber and Building Materials Stores, Hardware Stores, Paint Stores, Lawn and Outdoor Power Equipment Stores, Nursery and Garden Stores, Appliance Repair, and others. According to *IBISWorld*, there are four key economic drivers of the Home Improvement Stores Industry: per capita disposable income, private spending on home improvements, the 30-year conventional mortgage rate, and the number of households. (Phillips, 2014) Per capita disposable income is influenced by the unemployment rate, and the general state of the economy. The expected increase in per capita disposable income may result in both increased spending on home improvements and home purchases. Private spending on home improvements is further influenced by the growing trend of the Do-it-Yourself (DIY) mentality. DIY consumers are often seeking to avoid the additional expense of hiring a contractor to complete their projects.

Additionally, Lowe's and Home Depot have targeted their marketing to empower the DIY consumer to attempt these solo projects. The combination of expected increased per capita disposable income and DIY consumers may result in significant growth for the industry. The conventional mortgage rate influences consumers' ability to obtain the financing to fund home improvement projects. Lending practices and mortgage rates affect consumers' ability to either purchase a home, or obtain a home equity loan to leverage the equity in their homes. This is further compounded by the housing market, which can affect the home values and available equity used to borrow funds. The 30-year conventional mortgage rate is expected to rise, and may represent a threat to the industry. Lastly, the number of households is expected to increase, possibly leading to an increase in demand for the HISI products. While these key economic

drivers can either positively or negatively impact the industry, we feel that the economic drivers of the aforementioned sub-industries can provide additional insight.

The relevant economic drivers of the related industries, which vary from the HISI, are: housing starts, consumer confidence index, price of crude oil, demand from landscaping services, number of adults aged fifty and older, price of household appliances, and the price of sawmill lumber. Housing starts are expected to increase, and consumer confidence is expected to improve, which should represent an opportunity for revenue growth in the HISI. While the price of crude oil has recently fallen, it has historically fluctuated due to political instability and supply/demand concerns. The volatility of crude oil prices may potentially impact profit margins for the HISI. The demand for landscaping services is expected to increase and may represent an opportunity for revenue growth for the HISI, as landscaping service providers increase their spending on materials and equipment. Adults aged fifty and older represent the key demographic for Nursery and Garden stores. According to *IBISWorld*, the number of these consumers is expected to rise, although the growth rate of this key demographic is expected to slow over the next five years and may decrease revenue for the HISI (McKitterick, 2014). The price of appliances is expected to increase, and may result in consumers opting to repair, rather than replace their existing appliances and decrease revenue for the HISI. Additionally, the price of sawmill lumber is expected to rise, which may result in reduced revenues for the HISI, if consumer demand is decreased due to higher prices.

Company Background and Strategy

Lowe's

Lowe's is currently ranked number two in the Home Improvement Industry by revenues. In 2013¹, Lowe's generated \$53.4 million in revenues, which was an increase of 5.73% from the previous year. Lowe's was founded in 1946, as a small family-owned business, in North Wilkesboro, North Carolina. The company was incorporated in 1952 and has been publicly held since 1961. Ironically, the management of Lowe's initially desired to retain a small store "home town atmosphere", focusing on customer service. However, the company realized that it would be necessary to become a "big-box retailer" to allow for competitive expansion plans. Lowe's has realized a significant increase in the number of stores, mainly through both new store openings and acquisitions. Additionally, Lowe's has entered foreign markets with small expansions into both Canada and Mexico. Lowe's recently acquired Orchard Supply Hardware, primarily located in California, and operates 72 stores as a subsidiary. Lowe's and Woolworths began a joint venture in 2011 to open 150 Australian home improvement stores under the name Masters Home Improvement, and have opened approximately 50 stores thus far. ("Company History", n.d.)

The strategy of the company can be summarized as marketing to, and seeking to empower their customers. Lowe's strategy includes the continued investment in maintaining and upgrading its infrastructure, enabling the company to meet the needs of consumers. The development of project management tools and design and fulfillment capabilities will empower customers and allow for expedited delivery of products to stores and customers' homes. Lowe's

¹ Home Depot and Lowe's both have fiscal year ends "on the Sunday nearest to January 31," (The Home Depot, Inc. [Home Depot], 2014, 35) which in 2013 was February 2, 2014. This is referred to as "fiscal 2013" in their annual reports, and we will refer to it as "2013." The same applies to all years analyzed, 2009 through 2013.

is committed to investment in the people, processes, and tools for “Omni-Channel” experience (in-store, online, at home, phone). The company seeks to integrate all of these shopping channels, within a seamless framework, to improve the customer experience. A key part of this strategy is the MyLowe’s home management tool, which enables customers to access information related to all purchases. MyLowe’s allows the customer to access paint color formulas, product owner’s manuals, replacement parts, design ideas and many other features related to their prior purchases.

Lowe’s has targeted the ever increasing Do-it-Yourself (DIY) customer base, through both targeted advertising during popular television programs, and in-store workshops. This strategy will assist consumers, and enable them to believe they possess the knowledge and ability to complete various DIY projects, saving the labor costs associated with hiring contractors to complete projects. Additionally, Lowe’s continues to hire and train employees who can provide the knowledge and advice to customers, further bolstering the confidence of the DIY consumer. Finally, Lowe’s seeks to expand investment in international markets. Lowe’s plans to increase its international expansion, improving its market share since first entering Canada in 2007 and Mexico in 2010.

Home Depot

Home Depot is currently ranked number one in the Home Improvement Industry by revenues. In 2013, Home Depot generated \$78.8 million on revenues, which is an increase of 5.4% from 2012. Home Depot was founded in 1978 in Atlanta, Georgia by Bernie Marcus and Arthur Blank. The vision the founders had in mind when they started was a one-stop shop for the do-it-yourselfer. (“Our History”, n.d.) The first two stores opened in June of 1979, and the company went public in 1981. Expansion of the company through the 1980s was tremendous,

and in 1989 they opened their 100th store. This strong growth continued through the 1990s, during which time Home Depot expanded into Canada through the acquisition of Aikenhead's home improvement centers in 1994. In this acquisition, Home Depot acquired many of the over 100 stores they currently have in Canada. In 2001, Home Depot expanded into Mexico with the acquisition of Total HOME. The majority of the stores in Mexico come from that acquisition, although some are from further expansion.

Encouraged by the success of their expansion into Canada and then Mexico, in 2006 Home Depot decided to expand into the Chinese market with the purchase of The Home Way, a 12-store chain. Unfortunately, Home Depot misinterpreted the market in China. From a cultural standpoint, China has a much stronger do-it-for-me culture than a do-it-yourself culture. With Home Depot's traditional emphasis on the latter, the stores did not go over well. In 2012, only two stores were left in China, and neither were the "big box" style stores that we would recognize here in America. ("Home Depot closes...." 2012)

Home Depot's strategy is characterized by four features, each with its own measurable goals. The first three are referred to as the "key initiatives" and they are customer service, product allocation, and "disciplined capital allocation, productivity, and efficiency" (Home Depot, 2014, 2). They are woven together by the fourth feature, which is Home Depot's goal of "Interconnected Retail."

Home Depot's customer service strategy is focused on three distinct groups of consumers: the Do-it-Yourself (DIY) group, the Do-it-For Me (DIFM) group, and the Professional group of contractors and other people in the construction industry. In pursuit of excellent customer service, Home Depot reported in their 2013 annual report that they had achieved the goal of having 60% of their store labor hours dedicated to "customer-facing"

activities, which they believe will only help them serve each of the three groups of customers better. Toward their goal of product authority, Home Depot strives to bring what they call “innovative products” to their customers, as well as expanding online product availability. The strategy involving capital allocation has to do with making sure that they have a “best-in-class” information technology and supply chain systems. They are reportedly always looking for ways to improve their supply chain management in order to better serve their customers.

The concept of interconnected retail is a strategy that could work very well in Home Depot’s favor if they are continually able to have the interconnected system function the way they would like it to. As the company reported in the 2013 annual report, “Providing a seamless shopping experience across multiple channels, with an expanding array of merchandise, will be a key enabler for future success” (Home Depot, 2014, 2) To this end, Home Depot has been implementing three different services: buy online, ship to store (“BOSS”); buy online, return in store (“BORIS”); and buy online, pick-up in store (“BOPIS”). They are also working on rolling out a fourth service, “BODFS,” which stands for buy online, deliver from store. These are all aspects of the company’s interconnected retail strategy, and the logistical complexity of the three services explains the reason Home Depot believes their strategy and goal of interconnected retail connects the other three features of their strategy.

Financial Analysis

Common-size Income Statement

Using revenues as the base for Lowe’s and Home Depot, their common-size income statements are very similar through the gross profit margin. This is consistent with companies in a tightly competitive, commodity-driven market. Lowe’s selling, general and administrative

(SG&A) expenses are very steady across the five years, 2009 to 2013. Home Depot's SG&A expenses decline slightly from 24.0% to 21.1% over the five years analyzed. The only other material operating expense that either company included on their income statements is depreciation/amortization, which remained relatively steady, decreasing just slightly for both companies.

The decrease in operating expenses for Home Depot results in their operating profit increasing by 4.4%, from 7.3% to 11.6 % between 2009 and 2013. Lowe's operating profits also increased, but only by 1.2%, from 6.6% to 7.8%. Both companies had slight increases to their income tax expense lines over the five year, and no other gains or losses reported on the consolidated balance sheets. Finally, net income increased for both companies, but Lowe's net income increased by only 0.5%, while Home Depot's net income increased by 2.8%. Neither company disclosed any income contributable to non-controlling interest, so the percentages reported for net income attributable to common shareholders matched the reported net income.

Common-size Balance Sheet

The common-sized balance sheets use Total Assets for their base, per the norm. The assets section of each company's common-size balance sheet looks very similar at first glance: both increase and decrease on the same line items. Home Depot's percentages are just slightly more favorable than Lowe's.

Upon closer inspection of the common-size balance sheets, there are a few noteworthy differences. One of those differences is that Home Depot's cash and cash equivalents fluctuate more over the five years than Lowe's do. At the end of 2013, Home Depot's cash and cash equivalents grew by 1.3%, but they increased from 3.5% in 2009 to 6.1% in 2012, before decreasing to 4.8% in 2013. Lowe's cash and cash equivalents actually decrease by 0.7%

between 2009 and 2013, and while they do increase to 3.0% in 2011, they do not change quite as much as Home Depot's do. Another interesting difference is the fact that Lowe's does not have any accounts receivable reported on their consolidated balance sheet. In the Notes to the Financial Statements, Lowe's explains that they sell their accounts receivable to a third party servicer. (Lowe's Companies, Inc. [Lowe's], 2014)

A third difference is the fact that Lowe's does not include accumulated depreciation as a separate line-item on their consolidated balance sheet. The percentages for Lowe's Property, less accumulated depreciation line are quite similar to Home Depot's, once Property, Plant, and Equipment is netted with accumulated depreciation.

The final big difference between the two company's balance sheets is the fact that Home Depot has Goodwill reported on theirs, while Lowe's does not. According to Home Depot's Notes to the Financial Statements, Home Depot's expansions into Canada, Mexico and China account for much of that Goodwill. Goodwill is a place where the common-size financial statements can be misleading, at least for Home Depot. Note 1 and 6 to the consolidated financial statements mention that in 2012, the "goodwill associated with the former China reporting unit" was impaired, and a charge of \$97 million was recorded. (Home Depot, 2013, 38) However, goodwill as a percent of total assets increased from 2.8% in 2012 to 3.8% in 2013.

The Liabilities and Shareholders' Equity sections of the common-size balance sheets are where some bigger differences between the two companies become apparent. Lowe's current liabilities increased by 4.8% over the five years, while Home Depot's only 1.2%. Both companies are taking on long-term debt, and while Home Depot's long-term debt was 36.3% at the end of 2013, that is only a 15.1% increase from 2009, as compared to Lowe's long-term debt which increased 17.1%, from 13.7% to 30.8% over the five years. These and other minor

changes in the Liabilities section lead to Lowe's total liabilities increasing by 21.6%, while Home Depot's total liabilities only increased by 16.5%. The fact that both companies took on an increasing amount of debt year-over-year could be a warning sign to investors, but only if the companies have a low interest coverage ratio. As we will see in the Debt Utilization and Solvency analysis below, that is not yet the case for either company.

Looking at the Shareholders' Equity section, it is interesting to note that Lowe's common stock is much smaller as a percent of total assets (only about 2.0% on average) than Home Depot's (about 18.0% on average). In addition, Lowe's common stock decreased by 0.7%, while Home Depot's increased by 5.3%. The biggest oddity in the Shareholders' Equity section of the common-sized balance sheets is the fact that Lowe's retained earnings decreased 20.8% from 2009 to 2013 and Home Depot's increased by 24.9%. However, Home Depot also has treasury stock on their balance sheet, which increased by 45.9% over the five years. When Home Depot's change in retained earnings growth is netted with the change in their treasury stock, the result is a decrease of 21.1%, very similar to Lowe's decrease in retained earnings. This is explained by looking at Lowe's Notes to the Financial Statements. Lowe's also had treasury stock purchases over the five years in similar percentage amounts as Home Depot; Lowe's just elected not to show the treasury stock purchases on their consolidated balance sheet.

Profitability Analysis

Return on Assets

Return on Assets (ROA) measures a company's ability to generate earnings without considering the equity or debt financing of those assets. Lowe's and Home Depot's return on assets percentages moved in opposite directions during the five years analyzed. Lowe's ROA starts at 11.9% in 2009, drops to around 6.5% for 2010 through 2012, and the increases slightly

to 7.9% in 2013. This is a net decrease of 4.0%. Home Depot's ROA, on the other hand, started at 8.1% in 2009 and increased to 14.9%, a net increase of 6.8%. This means the Home Depot is doing a better job of efficiently using their assets to generate revenues than Lowe's is.

Return on Common Equity

Return on Common Equity (ROCE) measures a company's ability to generate earnings when also taking into account debt and equity financing. By this metric, too, Home Depot has more favorable results than Lowe's. Home Depot's ROCE in 2013 was 35.5%, a 21.2% increase from 2009. Lowe's ROCE in 2013 is 17.8%, which is actually a 0.9% decrease from 2009. This indicates that Home Depot is also doing a better job than Lowe's at using their assets, debt and equity to generate a return for investors.

Gross Profit Margin

Despite the differences in their ROA and ROCE percentages, Lowe's and Home Depot have very similar gross profit margin ratios year-over-year for the five years analyzed. Lowe's gross profit margin averaged 34.7% and Home Depot's averaged 34.4%. Home Depot's profit margin did increase by 0.9% while Lowe's decreased by 0.3%, but they are very comparable.

Cash Flow Analysis

Net Cash Flow from Operating Activities for Lowe's fluctuated slightly over the five years analyzed, ending at 4,111, while Home Depot's dipped slightly from 2009 to 2010, and then rose steadily through 2013 to 7,628. The cash flows from investing activities also fluctuated for Lowe's, although a little more widely than the cash flows from operations. Home Depot's cash flows from investing activities increased steadily.

As indicated in the common-size balance sheet analysis above, both companies have increasing cash flows from financing activities, although Home Depot's numbers increased more

dramatically than Lowe's, despite their percentage of debt in terms of total assets increasing less than Lowe's.

Asset Utilization

In general, Home Depot is doing a better job of utilizing their assets efficiently. Their turnovers are generally improving over time. Lowe's is doing less well at utilizing their assets efficiently. 2009 was something of an odd year for Lowe's, as we will discuss, and the rest of the company's asset utilization measures are deteriorating over time.

Accounts Receivable

One of the most interesting factors in comparing Lowe's and Home Depot is the fact that Lowe's sells their accounts receivable. That means that they do not provide investors a useful way to look at accounts receivable turnover, days receivables held, or net working capital days, nor the ability to compare those measures to another company.

Inventory

Except for 2009, when Lowe's inventory turnover was 7.5 times per year, Lowe's has a lower inventory turnover than Home Depot. Lowe's average inventory turnover for 2010 through 2013 is 3.9 times per year where Home Depot's is an average 4.5 times per year over the same period. This means that Home Depot is doing a better job of moving inventory through their stores, although not by a very large margin. Days inventory held for Home Depot has been decreasing slightly since 2009, from 87 days to 77 days, and Lowe's leveled out at 93 days for the last three years analyzed. Home Depot's reduction in Days inventory held is likely the result of their strategic efforts to streamline their inventory prediction and fulfillment processes.

Accounts Payable

As with the other asset utilization measures, Home Depot performs slightly better than Lowe's in their accounts payable turnover ratios and days payables held. Home Depot's accounts payable turnover increased from 8.9 times per year in 2009 to 9.3 times per year in 2013, and the days payables held decreased accordingly from 41 days to 39 days. Lowe's, on the other hand, had a huge spike in their accounts payable turnover in 2009, when it was 18.2 times per year, and then saw it drop to 7.3, which is where it stayed, with a few minor fluctuations, for the remaining four years analyzed. Other than 2009, when the days payables held was at 20 days, the company averaged 49 days.

Debt Utilization and Solvency

As we discussed in the common-size balance sheet analysis, Lowe's total liabilities increased more than Home Depot's did from 2009 to 2013, but Home Depot's total debt as a percent of total assets is higher in 2013 than Lowe's is. This difference is further confirmed when looking at the debt utilization and solvency measures.

Debt Ratios

Lowe's debt-to-equity ratio starts at 73.1% in 2009, but has reached 176.1% in 2013. That is an increase of 103.1%, which seems somewhat shocking considering the general theory that the higher a company's debt-to-equity ratio, the greater their long-term solvency risk. Home Depot's debt-to-equity situation looks even more extreme than Lowe's. Home Depot's debt-to-equity ratio increased from 110.8% in 2009 to 223.6% in 2013. That is an increase of 112.8%. However, an alternative perspective would be that these metrics showcase the size, general profitability, and capacity of each company to secure debt financing. This second interpretation is backed up by the analysis of the interest coverages ratios below.

The same story we see with the debt-to-equity ratio is repeated with the long-term debt to total capital ratio and the long-term debt to total equity ratio. Lowe's percentages start out lower than Home Depot's and, in general, increase by less. In 2013, Lowe's had a long-term debt to capital ratio of 46.0% and a long-term debt to equity ratio of 85.1%. Home Depot's percentages for those ratios were 54.0% and 117.3%, respectively.

Operating Cash Flow to Total Liabilities

This is the first debt utilization measure that is in Home Depot's favor. Even though Home Depot's debt load has increased dramatically, the company's operating cash flows to total liabilities ratio also shows an increase of 6.9% over the five years analyzed. This increase may not seem great considering how high the company's debt-to-equity ratio is compared to Lowe's, but over the same time frame, Lowe's operating cash flow to total liabilities decreased by 37.5%.

Interest Coverage Ratio

The interest coverage ratio is the other metric where Home Depot has outperformed Lowe's. From 2009 to 2013, Home Depot's interest coverage increased from 7.1 to 12.9, where Lowe's decreased from 10.8 to 8.7. This indicates to us that, despite the shocking increases in some of the other metrics, it would appear that Home Depot is still outperforming Lowe's, although Home Depot will have more cause for concern if their cash flows stop growing at the pace they have been.

Risk Analysis

The risks outlined by Lowe's and Home Depot in their annual reports are very similar across the board. At the firm-specific risks level, both face the risk that they will fail to attract, train, manage and retain qualified employees, as well as the risk that they will fail to "maintain the privacy and security of customer, associate, supplier or [c]ompany information," (Home Depot, 2014, 8) thereby damaging the company's reputation and opening the door to potential litigation. In addition, there is the risk that either company will "fail to achieve and maintain a high level of product and service quality" (Lowe's, 2014, 10) or they may be unable to "timely identify or effectively respond to customer needs, expectations or trends" (Home Depot, 2014, 7), which may adversely affect their sales and profitability, as well as their reputations.

As far as industry risks are concerned, both companies face the risk that a competitors' will be able to take market share if they are not able to effectively manage distribution, merchandising or marketing strategies. They also both have concerns about the risks from issues related to building and maintaining relationships with their brand-name and other third-party suppliers, as well as any as the risks posed by an issues they encounter implementing technological and supply chain improvements.

On the domestic risks level, both companies' continued successful operations are dependent on the continued stability of the economy, and any negative changes that affect the home improvement industry could have a negative effect on sales and operations as well. There is also the risk that changes in federal, state, or local legislation or regulations could negatively impact their operations.

As each company's supply chain becomes more global, there is also the international-level risk for both that of disruption to that supply chain could negatively impact their sales.

There is also the risk that the companies will improperly manage their continued international expansion efforts, which could damage their reputations and have a negative impact on earnings and long-term growth.

Risks for Lowe's

One of the risks that Lowe's included in their annual report that Home Depot did not is the payment-related risks that could "increase [their] operating costs, expose [them] to fraud, subject [them] to potential liability and potentially disrupt [their] business" (Lowe's, 2014, 10). Another risk that Lowe's highlighted that Home Depot did not was the risk that the company might fail to comply with a law or regulation in one of the foreign countries in which they operate, and that could subject the company to government enforcement, which might include fines or litigation. These are risks that Home Depot is likely also subject to, but they did not mention them specifically in their annual report.

Risks for Home Depot

Home Depot has had issues in 2014 with cyber security. The company's customer database was hacked and sensitive customer information was taken. This was one of the risks they listed in their 2013 annual report, and they wrote that if they were not able to "maintain the privacy and security of customer ... information, [they] could damage their reputation, incur substantial additional costs and become subject to litigation." (Home Depot, 2014, 8) A concern for investors in the wake of this data breach is what additional costs might Home Depot incur and how much will the litigation might they be subject to cost in addition to that? However, since Home Depot listed it as one of the known risks of doing business, it seems likely that they have a plan in place, and will use some of their earnings to set up an escrow fund for those costs, so they do not adversely affect the returns of their shareholders. It is also likely that, having been

hacked, they will improve their security more quickly than a company that has not yet been hacked.

In addition to being subject to cyber security failure, Home Depot also mentioned several other more theoretical risks in their 10-K that Lowe's did not. They included the potential risks to their business if they are unable to secure additional financing, if that becomes necessary. They also discussed the risks inherent in changes in accounting standards and the related assumptions made by management based on those accounting standards. Again, these risks seem more applicable to both companies, but Lowe's did not mention them specifically.

Financial Statement Analysis and Valuation

To do our financial analysis, we used the Cengage Financial Statement Analysis Package (FSAP), version 8.0. To calculate the required rate of return for our companies, we used the risk-free rate of 2.40% and the market equity premium of 6.0%. (Damodaran, n.d.)

Lowe's

Forecasting the Revenue Growth Rate

After running the analysis of Lowe's financial statements for the years 2009 through 2013, the compound annual growth rate (CAGR) for revenues was 2.0%. Even though the company's industry is mature and there is a lot of competition, this growth rate resulted in revenue forecast amounts that seemed low, considering how well the company did from 2010 to 2013. Speculating that the economic downturn in 2008 and 2009 has negatively influenced the growth rate, we decided to recalculate the CAGR using just the numbers from 2010 to 2013, which resulted in a rate for 4.5%. This new rate produced results that seemed a little high, so we calculated a weighted average of the 5-year CAGR and the 4-year CAGR, which gave us a growth rate for Year +1 through Year +5 of 3.9%. *IBISWorld* estimates that revenues for the Home Improvement Industry will increase at an annualized rate of 4.1% in the five years to 2019. Therefore, we feel that this slightly higher growth rate of 4.1% is comparable to our calculated weighted-average rate, and results in a more conservatively forecasted revenue growth rate.

Long-Run Growth Rate & Stock Valuation

Since the industry for these companies is mature, we initially picked a long-run growth rate of 2.0% for Lowe's. Lowe's market beta is 1.28 ("Lowe's Companies Inc.: Key Statistics," 2014). Therefore, the required return on common equity of 10.08%, results in an estimated value

per share of \$43.62. The share price for Lowe's on January 31, 2014 was \$46.29, which means that the actual share price was overvalued by 6%, according to our analysis. Additionally, we feel that an expected long-run growth rate of 4.1% for Lowe's is the most accurate, based on a comparison between our analysis and *IBISWorld*. Therefore, the required return on common equity of 10.08%, results in an estimated value per share of \$57.77. The most recent share price for Lowe's on November 28, 2014 was \$63.83, which indicates that the actual share price is currently overvalued by 9%

Home Depot

Forecasting the Revenue Growth Rate

After running the analysis of Home Depot's financial statements for the years 2009 through 2013, the compound annual growth rate (CAGR) for revenues was 2.0%. The CAGR was recalculated, as above, and ultimately it was decided to use the same conservatively forecasted revenue growth rate of 4.1%.

Long-Run Growth Rate & Stock Valuation

Since the industry for these companies is mature, we initially picked a long-run growth rate of 2.0% for Home Depot. Home Depot's market beta is 1.06 ("Mergent Online, Home Depot...", 2014). Therefore, the required return on common equity of 8.54%, results in an estimated value per share of \$71.90. The share price for Home Depot on February 2, 2014 was \$76.85, which means that the actual share price was overvalued by 6%, according to our analysis. Additionally, we feel that an expected long-run growth rate of 4.1% for Home Depot is the most accurate, based on a comparison between our analysis and *IBISWorld*. Therefore, the required return on common equity of 8.76%, results in an estimated value per share of \$100.09.

The most recent share price for Home Depot on November 28, 2014 was \$99.40, which indicates that the actual share price is currently undervalued by 1%.

Sensitivity Analysis

Looking at the sensitivity analysis chart for Home Depot (see Figure 1 below), if we were to choose a long-run growth rate of 3.0%, and a required rate of return of 8.0%, the value per share of the stock would be \$97.72, which would be slightly lower than the current share price of \$99.40. It is possible that our long-run growth rate assumption is too optimistic, and that a number closer to 2.5% or 3.0% would be more accurate, but we have opted to stay with our higher long-run growth rate assumption, as we feel confident that this represents a more realistic estimate of the industry's long-term growth rate.

FSAP OUTPUT:		VALUATION MODELS								
Analyst Name:		Megan Taylor								
Company Name:		Home Depot Inc								
Dividends Valuation Sensitivity Analysis:										
		Long-Run Growth Assumptions								
		100.09	0%	2%	3%	4.10%	5%	6%	8%	10%
Discount	5%	109.03	162.21	228.67	472.37	#DIV/0!	-369.51	-103.65	-50.48	
Rates:	6%	92.33	124.18	156.03	229.79	410.82	#DIV/0!	-162.46	-66.91	
	7%	80.37	101.31	119.63	154.37	211.23	394.45	-338.41	-94.12	
	8.40%	68.35	81.21	91.22	107.59	128.87	171.24	891.43	-188.86	
	9%	64.33	75.04	83.07	95.69	111.17	139.28	364.11	-310.39	
	10%	58.69	66.78	72.56	81.19	91.06	107.25	188.18	#DIV/0!	
	11%	54.05	60.33	64.65	70.85	77.61	87.97	129.42	336.68	
	12%	50.17	55.15	58.47	63.09	67.95	75.06	99.95	174.62	
	13%	46.88	50.89	53.50	57.05	60.68	65.80	82.20	120.47	
	14%	44.04	47.33	49.42	52.20	54.99	58.82	70.32	93.32	
	15%	41.57	44.29	45.99	48.23	50.42	53.37	61.79	76.96	
	16%	39.40	41.68	43.08	44.90	46.65	48.97	55.36	66.00	
	18%	35.76	37.40	38.39	39.64	40.81	42.33	46.27	52.19	
	20%	32.82	34.04	34.76	35.65	36.48	37.52	40.14	43.80	

Figure 1: Home Depot Sensitivity Analysis

Looking at the sensitivity analysis chart for Lowe's (see Figure 2 below), if we were to choose a long-run growth rate of 3.0%, and a required rate of return of 9.0%, the value per share of the stock would be \$59.87, which would be slightly lower than the current share price of

\$63.83. Again, it is possible that our long-run growth rate assumption is too optimistic, and that a number closer to 2.5% or 3.0% would be more accurate, but we have opted to stay with our higher long-run growth rate assumption, as we feel confident that this represents a more realistic estimate of the industry’s long-term growth rate.

FSAP OUTPUT:		VALUATION MODELS								
Analyst Name:		Jason Stevens								
Company Name:		Lowe's Companies, Inc.								
Dividends Valuation Sensitivity Analysis:										
		<i>Long-Run Growth Assumptions</i>								
		57.77	0%	2%	3%	4.10%	5%	6%	8%	10%
<i>Discount Rates:</i>	5%	79.07	118.24	167.21	346.76	#DIV/0!	-273.50	-77.63	-38.46	
	6%	66.75	90.21	113.68	168.02	301.39	#DIV/0!	-120.97	-50.58	
	7%	57.91	73.34	86.84	112.44	154.33	289.31	-250.62	-70.64	
	8.73%	47.35	55.91	62.42	72.84	85.93	110.61	362.75	-179.26	
	9%	46.07	53.96	59.87	69.17	80.58	101.28	266.93	-230.01	
	10%	41.89	47.86	52.12	58.47	65.75	77.67	137.30	#DIV/0!	
	11%	38.47	43.09	46.27	50.84	55.82	63.45	93.99	246.69	
	12%	35.60	39.26	41.71	45.11	48.69	53.93	72.27	127.28	
	13%	33.16	36.11	38.04	40.65	43.32	47.10	59.18	87.38	
	14%	31.05	33.47	35.01	37.07	39.12	41.95	50.42	67.36	
	15%	29.23	31.23	32.48	34.13	35.74	37.92	44.12	55.30	
	16%	27.62	29.30	30.33	31.67	32.96	34.67	39.37	47.21	
	18%	24.92	26.13	26.86	27.78	28.64	29.76	32.67	37.02	
	20%	22.74	23.64	24.17	24.83	25.44	26.21	28.13	30.83	

Figure 2: Lowe’s Sensitivity Analysis

Professional Financial Analysis

Standard and Poor’s Ratings

In October of 2013, the Standard and Poor’s (S&P) rating service raised Home Depot’s credit rating from an “A-“ to an “A,” which is where it has remained ever since. This is noteworthy because an A credit rating is “investment quality” (Associated Press, 2013). The S&P recommendation for Home Depot is to Hold, which has been their opinion since February 2014. They give it this recommendation based on the continued recovery of the housing market, as well as the strength of Home Depot’s balance sheet and their ability to generate cash flows.

The reason the recommendation is not Buy is due to the fact that consumer spending is declining and the housing market, while recovering, is recovering slowly. (McGraw Hill Financial, 2014)

Quite a few Wall Street Analysts agree with the S&P Hold Recommendation. Of 32 companies surveyed, 12 agreed that the stock should be held, while 13 opted for a Buy recommendation, six went with a more conservative Buy/Hold recommendation, and one chose to go with a Weak Hold recommendation. None of the analysts recommended the stock be sold.

Lowe's S&P credit rating has been steady at "A-" since before September of 2012 (Associated Press, 2012). This shows that the company is performing consistently, if not quite as well, in the S&P's opinion, as Home Depot. The S&P recommendation for Lowe's is also Hold, for essentially the same reasons as the recommendation for Home Depot.

There were 28 Wall Street Analysts' surveyed by the S&P for recommendations on Lowe's stock. Much like Home Depot, 12 of them agreed with the S&P's Hold recommendation, although only 11 had a Buy recommendation, while four chose the more conservative Buy/Hold recommendation. Only one analyst chose Weak-Hold as their recommendation, and none chose Sell. (McGraw Hill Financial, 2014)

Price-Earnings Ratio Analysis

According to the information reported on the S&P website, Home Depot's price-earnings ratio increased from 20.88 in 2011 to 26.47. Over that same time frame, Lowe's price-earnings ratio increased from 17.72 to 29.63. Lowe's price-earnings ratio increased by a much greater percent than Home Depot's. A higher price-earnings ratio can mean a stock is over-priced, especially when looking at older companies in a mature industry. And indeed, when we look at the financial analysis for Lowe's, we see that we did indicate that their stock is slightly over-valued, where Home Depot's is even more slightly undervalued.

Conclusion

According to *IBISWorld*, the Home Improvement Industry is a mature retail industry, with a high degree of market concentration. Home Depot and Lowe's represent slightly more than 80% of the market share in the industry, with the next closest competitor claiming merely 5%. Furthermore, Home Depot and Lowe's benefit from economies of scale, which indicates that they may each be able to remain more price-competitive and retain their respective share of the market. The estimated long-term growth rate for the industry is dependent on the key economic drivers of the industry. While we anticipate per capita disposable income, private spending on home improvements, and the number of households to increase, the 30-year conventional mortgage rate is expected to rise. The extent to which the interest rates fluctuate can have a significant impact on each of the other three economic drivers. Additionally, some of the risk factors of related industries, which are expected to trend unfavorably for the Home Improvement Industry, may increase expenses and decrease profit margins. However, it appears that the overall outlook for the industry is good and we have projected a 4.1% long-term revenue growth rate through 2019. We believe that both Home Depot and Lowe's have devised appropriate strategies of risk management, customer service (empowerment, focus, workshops), embracing technology, and international growth to remain competitive within the industry.

Amount to Invest

Based on our analysis, we are going to invest \$2,400,000 in Home Depot stock and \$600,000 in Lowe's stock.

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