

Impressive Earnings Despite Flat Same Store Sales

Home Depot (NYSE: HD) reported healthy third quarter earnings on November 13, 2001. While the company's efforts to improve operating efficiencies through its Service Performance Improvement (SPI) program resulted in record earnings and improved overall sales figures, same store sales were flat with last year's figures. For the near future, it will be interesting to see what effects the slowed economy will have on sales figures for the Q4 2001 and the first half of 2002. Also, can HD maintain or even improve upon its operating efficiencies and be successful in its attempt to instill a sales oriented mindset into its associates?

Financial Highlights

VP of Investor Relations, Bob Burton, opened the conference call by highlighting the company's impressive net earnings results for Q3 2001 of \$778 million or \$0.33 per diluted share, an increase of 19.7% compared with net earnings of \$650 million or \$0.26 per diluted share for Q3 2000. This increase represents a company record and was obtained in what Mr. Burton described as a "daunting retail environment."

Carol Tome, CFO, stated that HD saw its most profitable third quarter in company history (based on return on sales) despite the slow economy and the events of September 11. She did acknowledge flat same store sales figures, but highlighted the fact that gross margin, labor productivity, and expense controls were all up. Following are the significant financial and operational results for Q3 2001:

- Net earnings of \$778 million (\$0.33 per diluted share), up 19.7% from Q3 2000
- Sales of \$13.3 billion, an increase of 15.1% from Q3 2000
- Comparable same store sales flat with last year's figures
- Customer transactions grew 14.1%
- Average purchase per customer of \$49.03 flat with last year's figures
- G&A expenses down 3%
- Sales per labor hour at an all time high
- Average inventory per store down 8% from last year
- Inventory turnover at 5.4
- Days payable at 32 days versus 30 days last year
- Long-term debt is up as a result of the issuance of \$500 million in senior notes during the quarter
- HD expects to meet current Wall Street earnings projections of \$0.28 per diluted share for Q4, resulting in EPS for fiscal year 2001 of \$1.27, a 15% increase from the previous year

Ms. Tome pointed out that the company achieved 79% of its planned new store openings for 2001 by September. HD is on track to open 43 new locations in Q4 to reach or exceed the yearly goal of 204 new stores. She mentioned that HD owns 80% of its retail locations. One would wonder whether or not HD could further improve its operating margins by getting out of the real estate business and setting up more operating lease arrangements for its store locations.

HD Focusing on Improved Operating Margins, Efficiencies, & Salesmanship

After expressing his excitement about the earnings and total sales results for the third quarter, HD's President and CEO, Bob Nardelli, commented on the company's strategy for the quarter and how it plans to continue its efforts into Q4 and 2002. He reminded analysts that at the beginning of 2001, HD was concerned about the slowing economy and based its cost cutting/improved efficiency strategy on this concern. This strategy will carry forward into the next quarter and next year.

During Q3, HD completed the rollout of the Service Performance Improvement (SPI) initiative. The goal was to "increase efficiency in each of its 1,239 stores." The SPI initiative shifts most of the associates' handling of inventory to after-hours periods, so that there is more one-on-one customer service during shopping hours.

Mr. Nardelli also talked about another program known as the SOAR (Strategic Operating and Resource) planning proposal that is designed to create partnerships with key suppliers with the goal of better prices and less idle capacity. He spoke of merchant organization efforts with the following goals:

- Improved logistics with suppliers
- Package/pallet size optimization (for customers)
- Stronger and longer relationships with exclusive suppliers
- Innovation from suppliers

HD's healthy balance sheet has allowed it to make certain strategic acquisitions to aid in its growth. Specifically, the company is excited about acquisitions in Mexico and of its purchase of Your Other Warehouse, a special order plumbing distributor out of Baton Rouge, Louisiana. Mr. Nardelli spoke of the benefits of this acquisition-company's "new techniques" and high level of customer service.

Outlook

Bob Nardelli ended his portion of the call with a list of the issues that company will face in the near future:

- Continued stubborn economy
- Continued volatility in lumber prices
- Consumer confidence under pressure
- Slumps in new and existing home sales
- Hope that the lowered fed funds rates will trickle down to the 30-year mortgage rates and even further down into the do-it-yourself market

Q&A

The conference call ended with questions from seven analysts that follow HD.

A. Budd Bugatch with Raymond James

The first question dealt with the SPI program and its effectiveness. Specifically, the analyst wanted to know how the labor was being handled to achieve the goals of the program. Bob Nardelli explained that historical data showed that about 70% of the associates' time at work was spent with tasks such as stocking shelves, and only 30% for sales transactions. The goal of the SPI program was to shift the "70% task time" to evening hours when efficiency and safety is better. This would allow for better customer focus during shopping hours.

As part of the initiative, HD is trying to change the habits and mindsets of its existing associates so that they are more sales oriented. The company now wants not only associates with "product knowledge," but also with "selling knowledge." Hiring efforts are now more focused on finding more sales oriented employees.

B. Dave Ricci with William Blair & Co.

The second question was centered on the success/outlook for HD's EXPO Design Centers. These full-service type stores include many big ticket items that have been affected by the poor economy to a greater extent than the HD stores. Mr. Nardelli responded that rather than removing these big ticket items as a way of dealing with sales pressures in the EXPO centers, they will be working on trying to target customers' demands by stocking the "right merchandise," focusing on installation and service, and optimizing the labor load and staffing in the stores. There are more EXPO centers planned for construction in Q4 2001.

C. Daniel Binder with Buckingham Research

This analyst also inquired about the EXPO stores and was told that there are no plans to abandon the high-end products, but rather there are goals to broaden the product base to better suit customers' needs. Ms. Tome took the opportunity to point out that the new EXPO stores have been performing well.

Mr. Binder also asked about lumber pricing. Ms. Tome reiterated that prices were up 4% from last year and that they would remain somewhat volatile.

D. Wayne Hood with Prudential Securities

Mr. Hood asked about inventory levels. Ms. Tome responded by stating that the company expects inventories to get lower and lower at the store level as the company continues its efficiency improvement efforts, and that turnover is also expected to improve.

E. *Steve Baumgarten with Parker Hunter Incorporated*

This analyst congratulated HD on improvements he had witnessed personally as a result of implementation of the SPI program in one of the largest stores. He wondered how much HD projected sales to improve in existing locations as a result of the new initiatives. While no specific figures were given, Mr. Nardelli stated that he expected sales dollars per square foot per store and dollars per ticket to improve as a direct result.

F. *Gary Bolter with Credit Suisse First Boston*

Mr. Bolter asked about HD's appliance plan. Interestingly, the company's largest competitor, Lowe's, has become the second largest appliance retailer in the nation, second only to Sears. HD is testing appliance centers in some of its stores and indicated that this program was showing positive results and that they expect to expand appliance departments to more and more locations.

G. *Danielle Fox with JP Morgan*

This analyst asked about the sustainability of the cost reductions. Ms. Tome pointed out that the biggest expense for the company is payroll. She quickly remarked that as a result of the new initiatives, labor productivity has greatly improved and they expect these new levels to be sustainable. It was also mentioned that construction costs for new store locations have been decreasing.

Summary

In general, the company showed very favorable earnings and overall sales results for the quarter. Management was upbeat about the quarter and showed little concern about not maintaining current growth rates. Furthermore the analysts that asked questions of the executives showed support of the company's outlook.

There remain certain economic hurdles, and the company must continue to improve its operating efficiencies via the SPI initiative if it wants to remain profitable. I feel that an immediate concern should be the same store sales figures. The stock price on November 27, 2001 fell \$2.17, or 4.8 percent, to \$43.35 after a Merrill Lynch analyst suggested that the home-improvement retailer's new store sales are at an eight-year low, which he believes is the result of changing demographics.¹ Another concern should be dilution of HD's market share by Lowe's.

¹ CBS.MarketWatch.com. Jennifer Waters. Last Update: 5:25 PM ET Nov. 27, 2001