

Home Depot vs. Lowe's

Financial Analysis And Comparison

AIM 6344

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1) Background

1.1 The Home Depot

The Company was founded in 1978 in Atlanta, Georgia and has since become the world's largest home improvement retailer, operating more than 1,500 stores (Home Depot, EXPO, and other subsidiary companies) across North America. Home Depot caters to both do-it-yourselfers and professional customers who serve the home improvement construction and building maintenance market segments.

Today, Home Depot's stores stock up to 35,000 different kinds of building materials and lawn and garden products. Home Depot's unique services include free in-store clinics for home improvement skills as well as design and decorating consultation, truck and tool rental, home delivery, free potting and many others.

The Home Depot currently operates in 50 U.S. states and in the District of Columbia, eight Canadian provinces, and Mexico. In 1998, Home Depot opened stores in Puerto Rico and recently opened two sourcing offices in China.

1.2 Lowe's Companies, Inc

It is a \$26 billion retailer of a complete line of home improvement products and equipment. The company serves more than seven million do-it-yourself and commercial business customers each week through 875 stores in 45 states. Lowe's is the world's second largest home improvement retailer and the 14th largest retailer in the U.S.

Lowe's is in the midst of an aggressive expansion plan, opening a new store on average every three days. Lowe's is an active supporter of the communities it serves. Through the Lowe's Heroes volunteer programs and the Home Safety Council, it provides help to civic groups with public safety projects and share important home safety and fire prevention information with neighborhoods across the country.

Lowe's has been a publicly held company since October 10, 1961. Its stock is listed on the New York Stock Exchange, with shares trading under the ticker symbol LOW.

2) Industry

Due to the economic expansion over the 90s, the home improvement industry has experienced a rapid growth. Due to the wealth effect, consumers spent high amounts of cash and credit on improving their most prized and expensive possession, their homes. As a result, the home improvement industry experienced rapid expansion and growth. At its peak, the market reached a record level of \$377 billion in 2000.

There have been other key external forces influencing the industry besides the macro economic cycles, including changing customer needs, increasing percentage of household expenditure on building, wide spread use of the internet, and consolidation within the industry which shifts the industry market structure to oligopoly.

All the three major components of the market, namely do-it-yourself, buy-it-yourself and professional witnessed significant increases in sales. However, highest sales growth has been recorded in the home centers and maintenance service (6.9%). Previously, most of the market concentrated on mass or medium-market building material and home improvement and garden projects. But during the past five years, high-end design and renovation projects have developed remarkably.

Home Depot has changed the entire industry by initiating the warehouse store format supported by excellent customer service in 1978.

Industry's Key Success Factors

Analysis of customer demands and competitive strategies reveals the following industry key success factors:

DEMAND	COMPETITION	KSF
<ol style="list-style-type: none">1. One-stop shopping2. Low Price3. Convenient location4. Excellent customer service	<ol style="list-style-type: none">1. Super store concept2. Price based3. Fragmented market, many local competitors4. Provide quality customer care	<ol style="list-style-type: none">1. Wide Product Line2. Economy of scale/ cost efficiency3. Ability to expand by acquisition and new store opening4. Educated and trained sales force

3) Strategies

Home Depot's key success factors are excellent management, competitive prices, superior customer service, full range of product and expansive distribution channels. It has also invested and committed to build its web presents and e-commerce strategy to counter the new entries of many home improvement e-tailers.

Lowe's is targeting the customers who are interesting shopping for big-ticket appliances and high-margin home furnishings at its urban stores. Lowe's is pushing hard for growth to make up for lost time. The top home-improvement chain until the late 1980s, it was knocked off its perch as Home Depot embraced "big-box" retailing, while Lowe's clung to its small-town stores. Robert Tillman, 58, who has worked at Lowe's for 39 years, became CEO in 1996. A year later, fearful that Lowe's would forever lose out to Home Depot, Tillman began to open a handful of larger stores in metro areas. Now, Lowe's is accelerating that rollout just as Home Depot, which has saturated the largest markets, slows its expansion in order to squeeze more sales out of existing stores. To finance its expansion, Lowe's has added \$2 billion in long-term debt during the past two years. In recent years, Lowe's earnings gains have outpaced its big rival's. In the first quarter of 2002, same-store sales at Home Depot rose 5%. But Lowe's, which opened 46 stores in the quarter, did even better: Its same-store sales climbed 7.5%. Lowe's profits jumped 54%, to \$346 million, in the quarter. Home Depot failed to keep pace, as profits rose only 35%, to \$856 million.

The difference between a Lowe's store and a Home Depot has been fairly clear-cut up to now. Presentation counts at Lowe's. Its warehouse-style stores are laid out so that two shopping carts can pass in comfort, a feature that has helped Lowe's appeal to women shoppers. It has made a conscious decision to target women because, as Executive Vice-President for Merchandising Dale C. Pond says, "80% of [home] projects are initiated by females. Today, half of Lowe's clientele is female, and the chain is attracting more and more nonprofessional home-improvement shoppers.

Lowe's is also focusing more on higher-margin goods. Gross margins were 29.7% in the last quarter, up from 28.3% the year before.

Home Depot, meanwhile, has traditionally relied on low prices, lots of selection, and sales of building materials to professional contractors. But as Lowe's moves into bigger metro markets, Home Depot is apparently fighting it every step of the way. Home Depot has cut back its overall expansion pace. Some of those new stores are smaller "neighborhood" units, designed for urban markets such as Chicago and Brooklyn, N.Y., and Expo Design Centers, aimed mostly at women. Home Depot already has 48 of those centers, which provide decorating services and other high-end goods. In order to counter Lowe's huge share of major appliance sales which is 12.1% of the market is larger than any retailer except Sears, Roebuck & Co., Home Depot plans to build larger appliance sections in 200 existing stores and include them in new stores as well.

4) Financial Analysis

4.1 Adjustment to the financial statements

Both Home Depot and Lowe's use the new FASB methods on 2002 annual financial report, together with the comparable statement for prior years. They both use fair value method to report stock option expense; they both use FIFO method to record inventory. For goodwill, they both use the impairment method instead of amortization; when there're acquisitions, they both use purchase method to report.

Items we adjusted are:

For Home Depot:

1. Nonrecurring items

In note 9 of 2002 10-K of Home Depot, it was said that the company sold all of the assets of the Home Depot Chile S.A. in October 2001, which caused a gain of \$31 million. And during 2002, the company sold all of the assets of the Home Depot Argentina S.R.L., which caused a loss of \$45 million. These items should be reported on Income Statement as gain (loss) from discontinued operation.

NET EARNINGS from continuing operations	\$3,664,000,028	\$3,043,999,981	\$2,581,000,000
Gain(loss) from discontinued operations(net of tax)		(\$28)	\$19
Net Income	\$3,664,000,000	\$3,044,000,000	\$2,581,000,000

If remove the non-recurring items to reflect ordinary operation of Home Depot, net income would be:

Net Income	\$3,664,000,028	\$3,043,999,981	\$2,581,000,000
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2. Operating lease

To eliminate the potential earnings management provided by the off-balance-sheet item – operating lease, we capitalized the operating leases for Home Depot to reflect the real current and long-term liabilities, working capital and liquidity ratios.

(Here is a calculation for 2002 operating lease, we use the risk-free rate of 2002 as the interest rate, its 5%. The PV for operating lease of 2001&2000 are calculated as well.)

	Operating Lease	PV
1 2003	541	515.24
2 2004	512	464.40
3 2005	476	411.19
4 2006	440	361.99
5 2007	424	332.22
thereafter	4,915.00	2,902.45
TOTAL	7,308.00	4,987.47

3. SG&A

To make Home Depot and Lowe's financial ratios comparable, we combined two items from the operating expenses – Selling and Store operating & General and Administration to form one expense item: SG&A, which is corresponding to Lowe's SG&A.

For Lowe's:

1. Nonrecurring items:

The nonrecurring items for Lowe's are quite small, it's immaterial to the overall net income, so we did not remove them since the result would not change much.

2. Operating lease:

To eliminate the potential earnings management provided by the off-balance-sheet item – operating lease, we capitalized the operating leases for Lowe's to reflect the real current and long-term liabilities, working capital and liquidity ratios.

(Here is a calculation for 2002 operating lease, we use the risk-free rate of 2002 as the interest rate, its 5%. The PV for operating lease of 2001&2000 are calculated as well.)

	Operating Lease	PV
2003	212.00	201.90
2004	207.00	187.76
2005	205.00	177.09
2006	202.00	166.19
2007	201.00	157.49
thereafter	2,136.00	1,291.42
TOTAL	3,163.00	2,181.84

4.2 Ratio Analysis

4.2.1. Profitability analysis

Profit Margin			
	2000	2001	2002
Home Depot	5.64%	5.68%	6.29%
Lowe's	4.36%	4.65%	5.59%

Profit margin is a primary measure of a company's operating performance. It describes the operating efficiency of a company by showing how much of each sales dollar ends up as net income. Both Home Depot and Lowe's showed increasing profit margin ratios but Lowe's ratios were a little lower. That's due to Lowe's higher merchandise cost while they tried to keep at the same price level with Home Depot.

Gross Margin			
	2000	2001	2002
Home Depot	29.91%	30.15%	31.09%
Lowe's	28.18%	28.80%	30.30%

Gross margin shows the markup in price over the cost of goods sold. Both the companies had experienced increasing gross margin that is an indicator of their control over suppliers – since Home Depot and Lowe's are the most largest companies in the home improvement industry, suppliers' bargaining power is limited. At the same time, Lowe's showed lower ratios than Home Depot, mainly because their relative higher cost. But Lowe's almost caught up with Home Depot by the end of 2002.

ROA			
	2000	2001	2002
Home Depot	10.91%	10.68%	11.11%
Lowe's	6.96%	7.23%	8.74%

ROA is considered the best overall indicator of the efficiency of assets used in a company. Home depot maintained steady ROA ratio since 2000 while Lowe's has an increasing ratio that shows strong utilization of assets compared to Home Depot.

ROE			
	2000	2001	2002
Home Depot	18.88%	18.40%	19.34%
Lowe's	16.05%	16.91%	19.76%

This ratio is similar to ROA except that it shows only the return on the resource contributed by the shareholders. Home Depot maintained steady ratio and managed a modest increase. Lowe's on the other hand had experienced a nice growth and exceeded Home Depot in 2002. This is due to higher percentage of debt (or financial leverage) compared to Home Depot.

Asset Turnover			
	2000	2001	2002
Home Depot	1.93	1.88	1.77
Lowe's	1.6	1.55	1.56

Asset turnover depicts investment efficiency, because it shows how many sales dollars are generated for every dollar invested in the company's assets. Lowe's had relatively lower asset turnover ratios than Home Depot because their recent investment in PP&E has not yet reached their potentials.

SG&A to Sales			
	2000	2001	2002
Home Depot	20.44%	20.72%	20.91%
Lowe's	17.79%	17.67%	17.82%

This indicates the efficiency of the management for a company. Home Depot has a higher number than Lowe's and it is slowly increasing. That shows Home Depot is at an advantage in business management.

Current Ratio			
	2000	2001	2002
Home Depot	1.77	1.59	1.48
Lowe's	1.43	1.63	1.56

This ratio indicates a company's liquidity. It depicts how many dollars of current assets exist for every dollar in current liabilities. The ratio is the higher, the better. Home Depot has decreasing current ratio while Lowe's had a steady one. Home Depot's decreased current ratio was due to the increased current liabilities, mainly from the other accrued expense account.

Inventory Turnover			
	2000	2001	2002
Home Depot	5.32	5.63	5.33
Lowe's	4.42	4.57	4.87

This ratio is a good indicator of the relative liquidity of inventory. A high turnover ratio generally indicates efficient use of investment in inventory. Having an inventory turnover of 5.3, Home Depot is recycling its inventory every 68 days. Home Depot has a higher inventory turnover ratio that shows its higher operating efficiency but Lowe's is increasing its own inventory turnover year by year.

Debt to Asset			
	2000	2001	2002
Home Depot	42.39%	41.57%	43.42%
Lowe's	57.39%	57.15%	54.61%

The debt-to-total assets ratio describes the proportion of total assets supplied by creditors. The ratio can be used to help assess the risk of investing in or lending to a company. Home Depot has the lowest debt-to-total assets ratio in the industry. The financing of future projects will be less expensive for Home Depot because of its leverage. Lowe's will be at a disadvantage when trying to find sources capital for similar projects.

Debt to Equity			
	2000	2001	2002
Home Depot	73.59%	71.15%	76.74%
Lowe's	134.69%	133.35%	120.32%

This ratio relates how much debt a company has in proportion to its equity. Lowe's has much higher debt to equity ratios than Home Depot but it shows a decline in trend indicating that Lowe's financial health is getting better.

Long-term Debt to Equity			
	2000	2001	2002
Home Depot	11.96%	8.97%	9.15%
Lowe's	76.82%	83.57%	71.46%

This ratio is similar to debt-to-equity ratio except it only includes the long-term debt. Home Depot has much lower long-term debt to equity ratio than Lowe's that's because Lowe's has experienced a lot of financing activities for the purpose of expanding its business. The huge difference between the long-term debt-to-equity and debt-to-equity for Home Depot lies in its 80% portion of current liabilities to total debt.

5) Future and Prediction

According to our analysis we had a very clear picture of Home Depot and Lowe's. During the past decade Home Depot was the most successful retailer of home improvement industry. However, starting from the end of the 90's Lowe's has adapted a very aggressive and risky strategy of rapid expansion especially in Home Depot's own turf. This expansion was financed by massive loans which can be seen in "debt to equity" ratio of average 120% of Lowe's versus 74% of Home Depot.

This risky strategy has a very low tolerance for any negative developments and failure. Fortunately, things worked the Lowe's wished for and the home industry enjoyed a rapid expansion even in the recession years of the 2001 and 2002 due the historically low interest rates. Therefore Lowe's risky move has paid off and now the company is enjoying increasing sales more than that of Home Depot. Also Lowe's achieved profit margin and asset turnover rate equaling compared to Home Depot's.

The home improvement industry is still growing and with the help of growing housing market. Analysts are agreed that low rates will keep the market growing for the time being, however it not so optimistic for the near future where the rates are expected to move upwards as the economic expansion continues and FED abandons its position on low rates policy. Overall home improvement industry will enjoy satisfying growth level as the number of homeowners increase in the US. This also depends on three factors:

- 1) Mortgage rates
- 2) Growing population
- 3) Increasing personal income

As long as these factors are maintained in preferable levels, the housing market and related industry of home improvement will keep on growing. Our prediction for the industry is very positive as we expect the US population to maintain its 1.0% population growth, fueled by the constant immigration as well as the growing families. We are expecting the interest rates to increase from rock bottom levels of below 6% for 30 year mortgage to levels of 7.0% in 2004 based on the FED's recent predictions. This should have a pressure on the housing market but we believe the increasing levels of the personal income will compensate it. Our expectation on the economy overall is very parallel to that of the predictions of the economists and FED officials. Ultimately growing economy should help improving the personal incomes.

In the long run, we also bullish on the housing market and home improvement industry, even though it is considered overvalued at the moment. Home ownership rate is little over 60% in the US and we believe there is enough room for further growth in the future.

Home Depot

Home Depot has excellent performance and it should be able to maintain this in the future. It has the highest margins and value in the home improvement industry. It has high ROA and Gross Profit Margins but they are not showing signs of improvement.

The company was very attractive to investors in 90's but unless it adapts more aggressive growth strategies it will have difficulties of attracting future investors with its steady but slow growth. Besides, focusing on the competitive pressures from Lowe's it should get ready for the strong rivalry from Wal-Mart. Home Depot has created the home improvement industry but it will be Wal-Mart to take it over as it did for the other price sensitive retailing industries.

Lowe's

Lowe's has serious debt burden that increases its risk level drastically. Average 130% debt to equity is too much for any industry not to mention for retailing where the growth and margin levels are relatively lower compared to other industries such as high-tech. We are expecting Lowe's to slow down its impressive expansion and start paying down its debt. This could be a smarter move considering the expected slow down in the housing market in the short term due to higher interest rates.

Lowe's has caught a lot of attention in the investor community with the help of his impressive performance in the recent years. Though it has grown a lot, it is still the half the size of Home Depot. To keep growing at this pace, though, Lowe's has to battle Home Depot on its home turf, expanding into big markets such as Boston and New York. That looks like a risky strategy. There seems to be plenty of room to grow: Lowe's now has only 50% of its stores in metro markets. Therefore there is still considerable market share to gain. As soon as Lowe's fixes its debt ratio we are expecting its stock to perform much higher than its industry average.

Ratio analysis (Home Depot vs. Lowes)					
Home Depot, Inc					
		2000	2/2/2001	2/2/2002	2/2/2003
	Income Statement				
	net income		\$2,581,000,000	\$3,044,000,000	\$3,664,000,000
	net sales		\$45,738,000,000	\$53,553,000,000	\$58,247,000,000
	cost of good sold		\$32,057,000,000	\$37,406,000,000	\$40,139,000,000
	SG&A		\$9,348,000,000	\$11,098,000,000	\$12,182,000,000
	Balance Sheet				
	total assets	\$21,274,220,000	\$26,046,100,000	\$30,946,860,000	\$34,998,470,000
	current assets	\$6,390,000,000	\$7,777,000,000	\$10,361,000,000	\$11,917,000,000
	inventory	\$5,489,000,000	\$6,556,000,000	\$6,725,000,000	\$8,338,000,000
	total liabilities	\$8,933,220,000	\$11,042,100,000	\$12,864,860,000	\$15,196,470,000
	current liabilities	\$3,656,000,000	\$4,385,000,000	\$6,501,000,000	\$8,035,000,000
	long-term debt	\$750,000,000	\$1,545,000,000	\$1,250,000,000	\$1,321,000,000
	other long-term liabilities	\$237,000,000	\$249,000,000	\$372,000,000	\$491,000,000
	shareholder's equity	\$12,341,000,000	\$15,004,000,000	\$18,082,000,000	\$19,802,000,000
	net PP&E	\$10,227,000,000	\$13,068,000,000	\$15,375,000,000	\$17,168,000,000
Financial ratios					
	ROA		10.91%	10.68%	11.11%
	ROE		18.88%	18.40%	19.34%
	Current ratio		1.77	1.59	1.48
	Quick ratio		0.28	0.56	0.45
	debt to equity		73.59%	71.15%	76.74%
	Debt to asset		42.39%	41.57%	43.42%
	Inventory turnover		5.32	5.63	5.33
	Gross profit margin		29.91%	30.15%	31.09%
	Long-term debt to equity		11.96%	8.97%	9.15%
	SG&A to sales		20.44%	20.72%	20.91%
	COGS to sales		70.09%	69.85%	68.91%
	PP&E turnover		3.93	3.77	3.58

	2000	2001	2002
ROA			
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ROE			
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Home Depot	5.32	5.63	5.33
Lowe's	4.42	4.57	4.87
PP&E Turnover			
Home Depot	3.93	3.77	3.58
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Gross Margin			
Home Depot	29.91%	30.15%	31.09%
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Long-term Debt to Equity			
Home Depot	11.96%	8.97%	9.15%
Lowe's	76.82%	83.57%	71.46%
SG&A to Sales			
Home Depot	20.44%	20.72%	20.91%
Lowe's	17.79%	17.67%	17.82%
COGS to Sales			
Home Depot	70.09%	69.85%	68.91%
Lowe's	71.82%	71.20%	69.70%