Home depot argumentative essay

Team Project #1 Home Depot, Inc. in the New Millennium (HBS 9-101-117) Question 1. Assess Home Depot's financial performance from 1986 to 1999. What explains the decline in performance in 2000? (See Question #1 Exhibit) The slowing economy in 2000 combined with Home Depot's aggressive expansion efforts was the reason for Home Depot's poor financial performance. Between June 1999 and May 2000, the FED had raised interest rates six times – or a total of 1.

75 percentage points – in an effort to slow the economy and economists had been noticing some softening of overall consumer demand. From Exhibit 4 we see an average increase in sq. footage of 26% per year for period 1986 – 2000 while average sales growth fall from an average over the same time period of 31% to 19% in 2000. In addition Exhibit 4 shows there was a drop in sales per square footage from $423 in 1999 to $415 in 2000 and a drop in weekly sales per store from $876, 000 in 1999 to $826, 000 in 2000. An additional calculation derived from Exhibit 4 is the average number of customer transactions per store per year which had been on the steady increase from 1986 to 1996. However, the number of transactions dropped from 906, 250 in 1996 to 881, 410 in 1997 to 873, 850 in 1998 to 856, 989 in 1999, and finally down to 826, 279 in 2000.

Home Depot faced declining performance in 2000 from cannibalization of sales due to over expansion and market saturation. Resulting sales drops were also magnified by the slowing economy. Question 2. What is your estimate of the intrinsic value of Home Depot's stock as beginning of 2001, assuming that it will have a constant growth rate of 6% and maintain its same ROE as in 2000? Prepare a sensitivity analysis varying the cost of

equity and ROE. (See Question #2 Exhibit) CAPM = Rf +? (Rm-Rf) Ke =. 058+1.

09(. 07) Ke = 13. 43% ROE = . 209 G = . 06 V= BVE * (ROE-g)/(Ke-g) 12, 341*(. 209-.

06)/(. 1343-. 06) = 24, 748. 44 Value ranges from $25.

3B to $61. 2B depending on the cost of equity used (estimated by CAPM) with risk market premiums varying from 3-7%. However, further analysis of Home Depot's past returns, when standardized to a normal distribution with cumulative probabilities, the resulting expected return equated to 13. 3% (7. % higher than Rf) supporting the use of at least a 7% market risk premium. When we vary the ROE from 20.

9% (actual 2000 ROE) to 24. 9% (average 1986-2000 ROE) we then get a range of values from $25. 3 to $32. 1B Valuation is dependent upon our assumption of the market risk premium, and Home Depot's growth and ROE. Careful analysis on Home Depot's past performance does however allow for a considerable narrowing of the target valuation range. Question 3.

Compare Home Depot's performance to that of Lowe's. (See Question #3Exhibut & Supplemental Exhibits)Sales: HD sales as a percent to Lowe's have increased from 217% in 1997 to 243% in 2000. Sales growth for Home Depot is consistently 4% to 5% higher than Lowe's each year. Operating Turnover (sales/net assets): HD has outperformed Lowes through the expansion phase with a 5% drop in operating turnover while Lowes dropped 24% NOPAT: HD's NOPAT margin is slightly higher than Lowe's. Operating

ROA is over 5% higher at Home Depot than Lowe's. In conclusion, we believe the data analyzed, Sales, Operating Turnover, and NOPAT; favor Home Depot.

It has had higher increases in sales, better return on assets, and higher margins. Home Depot also has less debt and a stronger brand name than Lowe's. Question 4. Analyze Home Depot's Cash Flow Statements. Is Home Depot funding its investments out of internal cash flow or from external financing? Are dividends financed out of internal cash flow or by external financing? If Home Depot is using external financing, what percentage is debt financing? Common stock financing? (See Question #4 Exhibit & Supplemental Exhibits) Table (A) YearCFFOInvestmentsTotal 997 1, 100 (409) 1, 509 1998 1, 029 (194) 1, 223 1999 1, 917 (2) 1, 919 2000 2, 446 (32) 2, 478 If cash flow from operating activities less investments is negative, this would indicate that the firm is relying upon internal cash flow to fund their activities and therefore may not be sustainable. From this analysis, we see that Home Depot's CFFO – Investments is positive each year, they are relying on its external cash flow in order to maintain sustainability.

From their financials, we know Home Depot's cash flows do not cover CAPEX, but cover PP&E meaning there is a growth problem but enough cash flow from operating activities to cover capital expenditures required to replace worn out equipment. The recommendation would be to curtail spending its growth by acquisition strategy. YearNet EarningsCapital ExpendituresDifference 1997 $ 937. 00 $ 1, 194.

00 $ (257. 00) 1998 $ 1, 160. 00 $ 1, 420. 00 $ (260. 00) 1999 $ 1, 614. 00 $ 2, 053.

00 $ (439. 00) 2000 $ 2, 320. 00 $ 2, 581. 0 $ (261. 00) 1997199819992000 Working Capital 2, 469.

85 2, 344. 47 1, 601. 61 1, 376. 89 Working Capital / sales5. 4%6.

1%5. 3%5. 7% Sales 45, 738 38, 434 30, 219 24, 156 We can see based on the figures above that working capital is decreasing and not building up; therefore we can infer that Home Depot does not have an operating problem. ? Net income is smaller than cash flows and growing at a slower rate which indicates that Home Depot is not prematurely recording sales or using " cookie jar" accounting. It should be noted that cash flow is below net income in 1998 because of the one time acquisition charge of acquiring of the Molson Companies in The Home Depot Canada for $261 million.

Table (B) YearPayments for Bus. AcquiredPurchases of InvestmentsTotal 1997 $ – $ (409. 00) $ (409. 00) 1998 $ (61. 00) $ (194.

00) $ (255. 00) 1999 $ (6. 00) $ (2. 00) $ (8. 00) 2000 $ (101. 00) $ (32.

00) $ (133. 00) Table (C) YearCash & Cash EquivalentsDividends PaidDifference 997 $ 146. 00 $ (110. 00) $ 36.

00 1998 $ 172. 00 $ (139. 00) $ 33. 00 1999 $ 62. 00 $ (168. 00) $ (106.

00) 2000 $ 168. 00 $ (255. 00) $ (87. 00) In 1997 and 1998 there was enough cash on hand in order to pay dividends.

However, in 1999 and 2000, cash on hand was not sufficient to pay the dividend amount creating a need for external financing. Based on the figures above, we can see an increase in dividends paid, which correlates to a direct increase in external financing. Chart (A)Based on the chart above, we can see that Home Depot has a positive cash flow with an upward trend. We can see an increase of 54% in 1997 followed by 86% in 1999 and 28% in 2000. However, there is a single, isolated decrease of 6% in 1998 caused by the purchase of the remaining 25% partnership interest held by The Molson Companies in The Home Depot Canada for $261 million.

The excess purchase price over the estimated fair value of net assets of $117 million as of the acquisition date was recorded as goodwill and is being amortized over 40 years. CFFO – CFIA – Net Debt repayment – Preferred DividendsFrom the analysis above, we can conclude that the cash flow from operations to common equity holder's exceeds dividends in 1999 and 2000 therefore we can further support Home Depot is in fact using external financing to fund its operations, investments, and dividend payouts . From our previous analyses we concluded that Home Depot is utilizing external financing rather than internal to fund its operations and growth strategy. From the figures above we can further concur that from the external financing an average of 93% based on a four year period is going to debt financing while only 14% is going to common stock financing. From this inference we can see that the strength of its external financing lies within debt.

In addition, please note that if we remove the two outliers (108% and 53%), our split between debt and common stock financing is closer to 89% and 1%

respectively. We can see that in 1998, common stock financing was particularly high due to the acquisition of Home Depot Canada. Home Depot perceived the need of additional funding from common stock in order to facilitate this transaction.