

Relational investors and home depot essay

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JAY W. LORSCH KAITLYN A. S IMPSON Relational Investors and Home Depot
(A) We see ourselves as stewards of our clients' shareholdings. Proper stewardship requires active engagement of corporate leadership to spur improved performance.

Ralph V. Whitworth, Principal, Relational Investors, LLC, San Diego, CA In the summer of 2006, Ralph Whitworth, principal of Relational Investors, was considering investing in Home Depot. The stock price hovered around \$35. Whitworth had been watching Home Depot for a while because he felt it was underperforming and had potential for improvement. Moreover, the recent activities of the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) Office of Investment related to Home Depot really

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focused his attention on the company. The AFL-CIO Office of Investment had decided to concentrate its resources on several companies who seemed to have excess CEO pay, and chose to focus on Home Depot as a case study in compensation abuse.

Those in the Office of Investment believed that CEO Bob Nardelli had received exorbitant pay—total compensation of \$245 million from 2001 to 2006—especially in light of the 12% decline in the stock price during the same period. ¹ The AFL-CIO believed that an independent board would not have granted such compensation at a time when shareholders were doing poorly. After it became clear to the AFL-CIO representatives that the board would not reconsider his pay package, the tension around Nardelli's compensation erupted at the Home Depot annual meeting in May 2006. The AFL-CIO encouraged other shareholders to withhold votes from directors, and put forth a shareholder proposal recommending that shareholders have a “say on pay.”

“Approval of “say on pay” would give shareholders the right to an advisory vote on the CEO's compensation. The Home Depot board did not submit this proposal to a shareholder vote. In what became an infamous move, Nardelli instructed other Home Depot directors not to attend the meeting held in Wilmington, DE, so that he was the only director in attendance. Nardelli presided over the meeting using an electronic timer to limit shareholders to one minute to speak, after which their microphones were shut off. During his 60 seconds, Richard Ferlauto, the director of corporate governance and pension investment at AFSCME (one of the unions within the AFL-CIO) voiced his concerns about board independence at the meeting and then added: “ I <https://assignbuster.com/relational-investors-and-home-depot-essay/>

think it is absolutely outrageous that the board is not here. The board is too chicken to face the shareholders. ” 2 Meanwhile, AFL-CIO members protested outside the meeting, wearing chicken suits, yelling, “ Hey Bob, why are you chicken while the stock price takes a lickin’? ” 3 409-076 Relational Investors and Home Depot (A) 2 All of this described in news reports caused Whitworth to want to investigate further.

“ Home Depot had been coming onto our screens previous to May 2006, but it wasn’t really differentiated against other companies we were looking at. The activity of the AFL-CIO differentiated it,” said Whitworth. On the basis of research conducted by Relational’s analysts, Whitworth felt Relational had a good opportunity to improve Home Depot’s performance by arguing for a new strategy and a reallocation of capital, and thus restoring investor confidence. Ralph Whitworth After a childhood spent hopping from town to town in the Nevada desert with his geologist father, Whitworth moved east to attend law school at Georgetown. While there, Whitworth served as a legislative aide for Senator Paul Laxalt (R-Nev), which gave him a strong understanding of the changing landscape of corporate law and regulations.

Laxalt was campaign chairman for Ronald Reagan, and Whitworth worked on Reagan’s 1984 re-election campaign, learning the power of the media to advance a cause. After graduation, he joined Mesa Petroleum, the company founded by T. Boone Pickens. Working side-by-side with Pickens—an oil tycoon-cum-corporate raider-cum-shareholder activist—Whitworth became interested in revitalizing underperforming companies and improving corporate governance. With Pickens, he and his future Relational Investors co-founder, David Batchelder, took part in “ epic takeover battles” for oil and <https://assignbuster.com/relational-investors-and-home-depot-essay/>

mining companies. Prompted by falling oil prices in the early 1980s, Pickens' corporate raids were intended to reverse declining profits. Pickens amassed stock in oil companies he felt were poorly managed and could not easily resist his takeover bids. 6 Pickens did not consummate many bids, but his offers drove up the stock price of the companies he attacked, and he made millions of dollars when he sold his shares.

At the same time, Pickens publicized corporate abuses and shook up boards and management, which also raised returns for him and other shareholders in the targeted companies. Pickens' interest in shareholder rights led him to found the United Shareholders Association (USA), and he put Whitworth at the helm. Whitworth ran it from 1986 to 1994, pro bono, in addition to his private law practice. The purpose of USA was to strengthen corporate governance and make executives and boards more accountable to their shareholders, chiefly through shareholder proposals on issues such as greater board independence.

The organization also lobbied, along with other shareholder activist groups, to give shareholders greater proxy access. 7 As a result of this lobbying, the SEC adopted new proxy regulations in 1993. These lobbying efforts won shareholders the right to communicate with each other without SEC approval and improved executive compensation disclosure. By 1993, USA had grown to 65, 000 members, most of whom were individual investors. 8 In 1994, USA disbanded because the board members of the organization felt they had achieved their objectives. However, there were other reasons to close shop; in an article in the Wall Street Journal Whitworth explained: "The reason we had credibility and got CEOs to talk to us was because they thought we could

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embarrass them in the press, but that's not the best way to do it. It should be done with private relationships.

” Whitworth believed that “ the way to change corporate America [was] to focus on ‘ relationship investing,’ in which shareholders take a major stake in a company and try to change it from the inside. ” 9 In contrast to the raiders’ (like Pickens) strategy of well-publicized takeovers, relational investors, aided by the new SEC rules, sought to enhance shareholder value not by resorting to public change in control, but rather by buying shares and working with boards and management behind the scenes. Relational Investors and Home Depot (A) 409-076 3 Relational Investors In 1996 Whitworth joined with Batchelder, whom he had met while working for Pickens, to found Relational Investors. In 2008, the firm had about \$7.

1 billion under management. 10 Relational invested in eight to 12 companies at a time, with a 1% to 10% stake, and typically kept each investment in the portfolio for about four to seven years. 11 From its inception through 2006, the fund had returns of about 19% after fees and expenses. (Before fees and expenses, returns were about 24%. 12 95 percent of its clients were large public and corporate pension funds, 13 such as the California Public Employees’ Retirement System (CalPERS), which had provided the initial seed investment of \$200 million for the fund. 14 According to the fund’s website, it invested in publicly traded, underperforming companies that appeared to be undervalued in the marketplace.

Through intense and focused research, Relational’s principals developed an engagement plan to unlock value and create long-term growth. 15 They

invested in solid businesses with strong cash flow where they could bring about strategic change without intractable barriers. They often focused on companies where the core business was neglected due to over-diversification. The principals did not consider themselves operating experts in any industry, but they did consider themselves experts in strategic planning, capital allocation, compensation and corporate governance. They never sought control of a company; in fact, they had never waged a proxy fight. Whitworth and his colleagues used their own analytical framework to evaluate whether to invest in a company.

Once they decided to invest, they followed a particular process. First, they established a stake in the company and sent a letter to the company's board outlining proposals for improved performance and shareholder returns. If the company agreed to the changes, Relational increased its stake and kept persuading directors and management to implement its engagement plan. If the company refused, Relational often made its proposals public and invested further only when the company "gave up ground".¹⁶ In a limited number of cases, Relational's principals took a seat on the board. Combined, Whitworth and Batchelder had been on the boards of 18 public companies. Relational's Analysis of Home Depot Relational's analysis showed that Home Depot's business environment had changed significantly since the mid-1990s.

In particular, it faced greater competition and lower projected earnings and revenue growth (yet its strategic plan did not address many of these changes). Whitworth also began visiting Home Depot stores and informally querying staff, which reinforced the story told by the numbers. Relational

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concluded that Home Depot had lost its way in its quest to extend its growth. Hoping to reverse lagging growth, the board created incentives for Nardelli when he became CEO in December 2000. Essentially, he could make half a billion dollars if he could double Home Depot earnings and revenues," said Whitworth, " and between 2000 and 2006, the organization as led by him did just that—doubling earnings and revenues. He did everything that they incentivized him to do. But the stock price did not go up. " Whitworth's analysis indicated that the stock price was stagnating because of Nardelli's illfounded growth strategy and decreased investor confidence.

Nardelli had achieved revenue and earnings gains largely through cost cutting and diversification into the wholesale supply business. The cost cutting concerned Whitworth because it had eliminated many higher-paid, full-time employees with expertise, to the detriment of the customer service for which the chain had been so well known. Home Depot's slogan at the time was " You can do it, we can help," yet the annual 409-076 Relational Investors and Home Depot (A) 4 American Customer Satisfaction index showed that Home Depot was last among 15 major U. S. retailers—well behind Lowe's, its main competitor¹⁷ This was down dramatically from the late 1990s when the company had led the retail pack. The cutbacks resulted in short-term financial gains for Home Depot, but the decline in customer service hurt long-term sales and reputation.

Lowe's not only had better customer service, but also had tidier stores that drew more female shoppers. Lowe's also focused exclusively on retail, and though it was smaller than Home Depot, it was growing faster. As a result of

these factors, Lowe's stock price jumped from \$11 to \$31 between 2000 and 2006, while Home Depot's stock price fell from \$44 to \$40.

18 Whitworth was also worried about the effect of diversification on Home Depot's performance. Nardelli had spent \$7 billion acquiring 27 companies to build the wholesale business to service the professional contractor market. 19 (See Exhibit 2 for an explanation of why Home Depot, as led by Nardelli, entered the wholesale supply business.) According to Whitworth, the wholesale unit was a double blow to stock performance. First, it detracted management from the retail business at a time when competitor Lowe's was gaining market share. 20 But just as importantly, in Whitworth's estimation, it also diluted the company's overall returns and increased earnings volatility. Whitworth said: Our calculations demonstrated that Home Depot was earning below its cost of capital on the wholesale business, while the core retail franchise consistently experienced returns above 20%. The growth-vs.

-return trade-off for the wholesale business was a net negative within the Home Depot business solution. The bottom line was that shareholders were unwilling to pay as much for earnings from the wholesale asset as they had historically paid for those from the retail franchise, and Nardelli was essentially telling them that Home Depot's growth was projected to come from wholesale. Thus, a stagnating share price even after doubling earnings.

He delivered earnings growth and P/E multiple contraction for a zero sum game. The wholesale business also hurt credibility. Management had forecast that the return on invested capital from the wholesale business

would improve over time, whereas Relational's analysis showed that the implied targets would take decades to achieve. This unrealistic goal damaged investor confidence, yet Whitworth said this perception could be reversed. Increased credibility and confidence would drive the stock price and help raise the P/E multiple. Whitworth believed that many of the causes of declining performance were rooted in the compensation incentives the board had established for Nardelli. He said, " Whether it was a mistake to hire Nardelli based on his skill set is really a question I leave aside. Where the board really made the big mistake was the type of incentives they set up.

" In Whitworth's experience, it was not uncommon for boards to focus on growth, yet fail to improve earnings and performance. He said: The allure of growth is so great, because of what directors instinctively know it can do for the stock price. That is what draws boards into this trap over and over again. What they miss is that all earnings are not created equal and that growth for growth's sake does not move the needle. They fail to ask " growth at what cost? " And they fail to put a capital charge in the incentive calculation. What moves a stock price is growth associated with high or increasing returns. The returns in mature companies invariably get left out of the strategic vision.

We have some research that we present to the managements and boards of our portfolio companies that shows that in a typical single-digit-growth company about 80% of stock price is attributed to returns, and only about 20% to growth. In mature companies the market exacts a huge penalty for diluting returns. And, worse, because markets look ahead, the penalty comes Relational Investors and Home Depot (A) 409-076 5 before the dilution if it's <https://assignbuster.com/relational-investors-and-home-depot-essay/>

in the projection. But the way boards end up looking at it, and the way they make their decisions, you would think it was 20/80 or the exact opposite. Whitworth explained why Relational decided to invest in Home Depot: “ Our decision to get involved was the convergence of our estimate of what the value could be with the proposed changes and then our estimate of how likely it could be that we could cause those changes. ” In his assessment, Whitworth saw an opportunity to add value through increased performance in the following areas:

- Exit wholesale supply and focus on realistic growth objectives in the core retail business
- Embrace the core retail business and make a concerted effort to recapture the old customercentric Home Depot appeal
- Establish sound capital allocation processes and disciplines; repurchase stock or return cash to shareholders in dividends if investment in the retail business has been maximized
- Create a clear and realistic strategy to reestablish investor confidence (including CEO compensation that is aligned with shareholders’ interests)

Whitworth estimated that the value added from earnings growth, a shareholder dividend, the sale of the wholesale unit, and exclusive focus on the retail business would double the Home Depot stock price by 2010. He also predicted that the P/E ratio would increase from 14 to 18 in the upcoming year. In addition to the value of the proposed changes, Whitworth thought Home Depot was a good investment because shareholders would likely support the changes he proposed.

Many shareholders were upset because of the way the management had handled the 2006 annual meeting. Whitworth said, “ We’re not in a mode of trying to persuade anyone. We want to know if the sentiment is already there and then perform a catalyst function.

We did some informal surveys of the shareholder base. Nardelli had really lost their confidence. They were very dissatisfied and anxious for change. ”

Relational Invests in Home Depot At the beginning of December 2006, Relational made an initial investment in Home Depot of about 13 million shares—a 0.6% stake.

21 On December 13, Whitworth sent a letter to Nardelli, informing him of the investment and outlining the causes of poor stock price performance. (See Exhibit 1 for Whitworth’s letter to Nardelli.) If the board did not form an independent committee to reassess its strategy, Whitworth said he intended to launch a proxy contest for board seats. He also requested a meeting with Nardelli and members of the board. In a brash move, Nardelli made public Whitworth’s letter and announced that he would oppose the shareholder proposal.

Whitworth said: He made what turned out to be quite a serious tactical error. I don’t know if he just wanted to take his money and go at that point. What he did was really unusual. Normally, we send that letter and the company will contact us, we have a couple of meetings, and it will not be publically known.

About 70% of our projects the world never knows we are working on. What we found out later is that Nardelli acted on his own, without buy-in from the board. On December 18, Whitworth received a letter from Frank Fernandez, the corporate secretary of Home Depot. Fernandez said that the board would not reconsider the current strategy, but was 409-076 Relational Investors and Home Depot (A) 6 willing to meet with Whitworth “ shortly after the first

of the year. ” 22 By the end of December, Relational increased its stake in Home Depot to about 25.6 million shares, raising its ownership of the company to 1.26%.

23 On January 2, 2007, Nardelli stepped down as CEO. Home Depot sources attributed it to his refusal to accept a pay cut. Other sources credited Whitworth as the driving force behind his departure. 24 Whitworth Meets With the Home Depot Board The next day, Frank Blake became CEO of Home Depot. He accepted a 2007 pay package that was about one third of the total compensation Nardelli received in 2006—not to exceed \$8.9 million, and more closely tied to the long-term stock price.

25 Whitworth and Batchelder met with Blake and three board members on January 25 to present Relational’s recommendations. Their primary request was that the board sell the wholesale business and refocus the company’s capital allocation. Whitworth explained: “ The management had been making presentations to the board and to Wall Street that said that their acquisitions in the wholesale supply business were experiencing a 13% return on invested capital. Our calculations showed that it was 7%. ” The board members were stunned when Whitworth explained the discrepancy. He said, “ What we found out—and this was in a footnote in one of their presentations—was they calculated returns using the beginning period capital and the ending period revenues.

They were adding revenues through the year, but were not charging for the capital. When we told the board that and showed them the footnote, it was quite a dramatic moment. ” The directors agreed to consider the sale of the

wholesale business and within just a few days they offered Relational a seat on the board. The directors wanted to avoid a proxy fight, and having a large shareholder on the board would also improve the general investor perception of Home Depot. In addition, after seeing the depth of Relational's analysis, they were convinced that Relational could add value.

Whitworth said it usually takes a few board meetings for other directors to gain trust in them, but " once they see that [we] aren't there for some social or other agenda, they quickly say, ' If there's a way to improve this place, let's do it. '" 26 Batchelder Joins the Board Relational accepted the board seat, although historically the principals had sat on boards in only about 20% of their investments. Whitworth explained why the situation at Home Depot warranted joining the board: " The needed changes were complex and multiple. There was a value to be added by being directly involved, to try to see that change happened effectively and on a timely basis.

" Relational wanted to participate in decision-making, too. On February 22, 2007, Batchelder formally joined the Home Depot board and Relational withdrew its nomination for a board seat. 27 According to the Wall Street Journal, Home Depot would " nominate and support Mr. Batchelder or another Relational Investors recommendation to the board for each of the next three years as long as the investment fund continues to own a significant stake in the company. 28 Relational Investors and Home Depot (A) 409-076 7 Exhibit 1 Letter from Whitworth to Nardelli to Announce His Investment in Home Depot December 13, 2006 Mr. Robert L. Nardelli Chairman, President and Chief Executive Officer The Home Depot, Inc. 2455 Paces Ferry Road Atlanta, Georgia 30309-4024 Dear Mr.

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Nardelli: We have recently become a significant shareholder of Home Depot Inc. (the “ Company”). We believe the Company’s board of directors is presented with enormous responsibility and opportunity to reverse the Company’s chronic inferior stock price performance experienced since 2000. We attribute this performance to deficient strategy, operations, capital allocation, and governance. We are planning an advocacy program designed to spur positive action to address these deficiencies.

In that vain [sic], under separate cover we have submitted the attached Notice of Shareholder Proposal. This notice was timed to satisfy the deadlines set forth in the Company’s Bylaws. We would like to meet with you and representatives of the Company’s board of directors at the earliest convenient time. At that meeting, we would like to discuss this proposal and other steps we are considering, which include nominating one or more directors for election to the Company’s board of directors of the Company’s 2007 Annual Meeting of Shareholders. I look forward to hearing from you. If you would like to reach me, you can call my office at (858) 704- 3330.

Sincerely, Ralph V. Whitworth, Principal Source: Home Depot News Release, “ The Home Depot to Oppose Shareholder Proposal From Relational Investors: Letter to Robert Nardelli from Relational Investors,” December 13, 2006, company website, [http://ir.](http://ir.homedepot.com/ReleaseDetail.cfm?ReleaseID=222712)

[homedepot. om/ReleaseDetail. cfm? ReleaseID= 222712](http://ir.homedepot.com/ReleaseDetail.cfm?ReleaseID=222712), accessed January 2009. 409-076 Relational Investors and Home Depot (A) 8 Exhibit 2 Nardelli’s Rationale for Entering the Wholesale Supply Business (1) Excerpt from Bob Nardelli’s Letter to the Shareholders, March 29, 2006: “ The professional contractor market is twice the size of the Do-It-Yourself (DIY) business <https://assignbuster.com/relational-investors-and-home-depot-essay/>

We can repeat in the pro market what we did in retail in the ' 80s and ' 90s, with both speed and sustainability. Back then, we transformed a fragmented, inefficient, local and stagnant market into a consolidated, efficient, international and innovative market.

Given our scale and vision today, we have the same opportunity in the professional arena, but our position is much more formidable. We're off to a fast and strong start. Indeed, 2005 was a turning point. We completed 21 acquisitions to better service professional contractors and announced several others, adding to our distinctive portfolio of category leaders, such as National Waterworks, Contractors' Warehouse, Williams Bros.

Lumber Company and Chem- Dry. In 2005 we announced Hughes Supply, the largest acquisition in our history. Through close coordination between our stores and our branches, we will provide unmatched services to our existing base of professional customers as well as to new customers. " Source: Home Depot, 2005 Annual Report (Atlanta: Home Depot, 2006), p. 2.

(2) Excerpt from a Financial Times article: " Home Depot has spent about \$6 billion over the past two years acquiring more than 20 businesses, including Hughes Supply, a large building products company, and National Waterworks, a supplier of water and sewerage infrastructure. The wholesale division already accounts for about 10% of total revenues and Mr. Nardelli expects it to reach double that proportion by 2010. At \$410 billion, the American wholesale market is more than twice the size of the DIY market and highly fragmented, giving Home Depot the opportunity to lead

consolidation. Some investors are uncomfortable with the expansion into a market that has lower margins and greater complexity than retailing.

But analysts have grown steadily more enthusiastic as strong growth from the new division has offset the slowdown in retail sales. ‘ People are starting to get it,’ says Mr. Nardelli. ‘ We are better positioned to handle economic cycles because we are broadening our platforms. David Strasser, analyst at Bank of America, says diversification is reducing the company’s exposure to the consumer slowdown because the wholesale market is correlated with industrial production, which remains strong. ” Source: Andrew Ward, “ Does it Stack Up? Why Home Depot is Putting Its Faith in Wholesale Growth,” Financial Times, September 8, 2006, p. 13.

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