Home depot financial analysis essay

HOME DEPOT INC. (Note: all $ amounts are stated in millions) PART 1

a)There are 3 years covered in the following primary comparative financial statements, namely fiscal years ended 1 February 2004, 2 February 2003 and 3 February 2002: •Consolidated Statement of Earnings •Statement of Stockholders Equity and Comprehensive Income •Consolidated Statements of Cash Flows There are 2 years covered in the Consolidated Balance Sheet, namely fiscal years ended 1 February 2004 and 2 February 2003. All of the primary comparative financial statements were audited, namely the Consolidated Balance Sheet, the Consolidated Statement of Earnings, the Statement of Stockholders Equity and Comprehensive Income and the Consolidated Statements of Cash Flows.

The auditors were KPMG LLP. The auditor's conclusions about these Statements (i. e. the audit opinion) was that the Consolidated Financial Statements present fairly, in all material respects, the financial position of Home Depot and its subsidiaries in conformance with accounting principle generally accepted in the United States of America. The auditors also highlight that there was a change in the method in which the Company accounted for cash considerations received from vendors. This information was found in Note 1 (Summary of Significant Accounting Policies – Fiscal Year) to the Consolidated Financial Statements and in the Independent Auditors' Report.

b)The details relating to changes in the amount of retained earnings are found in the Consolidated Statement of Stockholders' Equity and Comprehensive Income. c)1. Operating activities: All years – positive 2. Investing activities: All years – negative 3. Financing activities: All years –

negative The Cash balance increased from 4 February 2001 to 3 February 2002, decreased from 3 February 2002 to 2 February 2003 and increased from 2 February 2003 to 1 February 2004.

This information was found in the Consolidated Statements of Cash Flows.

d)The amount of net sales during the fourth quarter of the fiscal year ended 1 February 2004 was $15 125. The amount of net sales during the fourth quarter of the fiscal year ended 2 February 2003 $13 213. The percentage change is therefore a 14. 5% increase ((15125-13213)/13213 * 100). This information is found in Note 10 (Quarterly Financial Data – Unaudited) to the Consolidated Financial Statements.

The pattern of quarterly net sales, as seen in the graph above, is consistent from year to year. The general trend of net sales in each year increases in the 2nd quarter and steadily decreases in the 3rd and 4th quarters. The increased sales in quarter 2 could have resulted from volume drives (i. e. by increase in promotional activity), particularly due to the anniversary of the store opening being in this quarter.

The overall sales pattern could be explained by seasonal fluctuations in demand. One possible reason for this is that the majority of Home Depot products are outdoor related in nature, which will attract an increased demand in quarter 2, which falls in the US Summer season. Another possible reason for an increase in sales in quarter 2 is if their annual price increase takes place in quarter 3. This would create an increase in demand for goods prior to the price increase taking effect, increasing sales in quarter 2, with a resultant steady decline in sales for the remainder of the year.

e)Management are of the opinion that the company's financial condition remains strong. The key indicators of this, in management's opinion, are: •Growth in sales •Increase in comparable store sales •$2. 9 billion in Cash and Short Term Investments •Low debt-to-equity ratio of 6. 1% •Improvement in return on invested capital of 20. 4% •Opening of 175 new stores •Percentage relationship between net sales and selling and store operating expenses, pre-opening expenses, general and administrative expenses, interest income/expense and provision for income taxes Information found in Management's Discussion and Analysis of Results of Operations and Financial Condition.)Interest rates Management's assessment of risk associated with interest rates is high.

Exposure to market risks results primarily from fluctuations in interest rates. Their objective is to enter into derivative instruments to primarily decrease volatility of net earnings and cash flow associated with fluctuations in interest rates. They have financial instruments that are sensitive to changes in interest rate, as well as several outstanding interest rate swap agreements. Changing prices Management's assessment of risk associated with changing prices is low. There is no material effect on Net Sales or results of operations. Therefore, there is no material risk.

Self insurance Management's assessment of risk associated with self insurance is medium. Home Depot is self insured for certain losses related to general liability, product liability, workers' compensation and medical claims. They believe the estimates are reasonable, however, if actual trends differ from estimates, the results of operations could be impacted. Information found in Management’s Discussion and Analysis of Results of Operations and Financial Condition. PART 2)Refer to workings 1 to 4 in the Annexure.

1 Feb 20042 Feb 2003 1. Current Ratio1. 4: 11. 5: 1 2. Quick Ratio0. 4: 10.

4: 1 3. Amount of working capital$3, 774$3, 882 4. % change in working capital-2. 8%0. 6% 5. % change in cash and cash equivalents 29.

2% 11. 7% b)Liquidity has decreased marginally. There is a decrease in the amount of working capital, as well a decrease in the current ratio. Although the quick ratio has remained the same, both the current and quick ratio’ could be considered to be low as the accepted norm is 2: 1 for the current ratio and 1: 1 for the quick ratio.

However, these norms may be misleading as Home Depot may be converting their receivables and inventory into cash (as evidenced by the increase in the amount of cash and cash equivalents) at a quicker rate than their payables. Furthermore, ratios from similar companies and industry wide averages should also be considered. The decrease in the current ratio is due to changes in inventory levels, as the quick ratio has remained the same. c)The company should also consider whether payments can be made timeously. The following should be calculated to determine both the ability to pay and the likely timing of payments: solvency ratio •debt ratio •interest cover •debtors days/turnover •inventory days/turnover •creditor days •operating cycle •unused lines of credit d)Memorandum regarding credit rating To: Home Depot Management From: Company X We have assigned a credit rating to Home Depot of ‘ B’ – Good.

Although the company's liquidity decreased marginally, you are still able to pay your debts as they become due. Home Depot has sufficient cash and cash equivalents on hand, and there has been an improvement in the cash conversion cycle. This has resulted in an increase in the amount of cash and cash equivalents in fiscal year 1 February 2004. Whilst there will be a strain on cash due to capex programs (opening of new stores), Home Depot has sufficient funds available from the commercial paper program. This program allows borrowings for up to $1 billion.

Home Depot also has a back up credit facility with a consortium of banks for up to $800 million. PART 3 a) Refer to workings 5 to 10 in the Annexure. 1 Feb 20042 Feb 2003 % change net sales11. 3%8. 8% % change net earnings17.

5%20. 4% GP rate31. 8%31. 1% Net income as % of sales6. 6%6.

3% ROA21. 2%20. 7% ROE20. 4%19.

3% b) Profitability Ratios: (i)Net sales growthNet sales growth has increased from a rate of 8. 8% in 2 Feb 2003 to 11. 3% in 1 Feb 2004. This growth could have originated from price growth (effect of price increase) and/or volume growth (increased sales due to opening of new stores and increase in product range). Whilst the growth is still positive, this is at a lower rate that that achieved in the previous five years (average growth of 22. 4% – Refer to working 11 in the Annexure).

One possible reason for this is the US economic expansion in the 1990's which lead to a rapid growth in the Home Improvement industry. ii)Gross

Profit (GP) rate: The Gross Profit rate has increased from a rate of 31. 1% in 2 Feb 2003 to 31. 8% in 1 Feb 2004. There has been a consistent improvement in this ratio for the past eight years.

The following reasons are attributable to the GP rate increase: -change in customer preferences (purchase of product with higher margins – mix ratio) -continuing benefit arising from the centralized purchasing group -improved inventory management resulting in lower shrinkage levels -increased penetration of import products with lower costs benefits from tool rental centres (iii)Net income as a % of sale Net income as a % of sales has increased from a rate of 6. 3% in 2 Feb 2003 to 6. 6% in 1 Feb 2004. On average, there has been a consistent improvement in this ratio for the past eight years. Although certain costs (selling and admin, increase in workers compensation, general liability expense and costs associated with the store modernization program) increased in 1 Feb 2004, these have been offset by improved sales productivity.

(iv)% Change in Net EarningsThe % change in net earnings has decreased from a rate of 20. 4% in 2 Feb 2003 to 17. 5% in 1 Feb 2004. Although there has been an increase in net sales, costs relating to selling and store operating (increase in no. of stores and advertising), general administrative (due to increase costs in technology and other growth initiatives), interest (due to financing of new stores) and income taxes have increased in relation to net sales.

(v)Return on Assets (ROA) ROA has increased from a rate of 20. 7% in 2 Feb 2003 to 21. 2% in 1 Feb 2004. This improvement has been achieved even though the asset base increased with the opening of new stores, therefore highlighting that the opening of new stores has been profitable (value added). (vi)Return on Equity (ROE) ROE has increased from a rate of 19.

3% in 2 Feb 2003 to 20. 4% in 1 Feb 2004. On average, there has been a consistent improvement in this ratio for the past eight years, which is a very positive indicator to the watchful eyes of many investor/shareholders. Conclusion: Based on the analysis above, it can be concluded that Home Depot is a consistently profitable business. There has been a steady increase in the Gross Profit rate with adequate steps to monitor the increase in sales and operating costs.

To date, shareholders will be satisfied with the returns from the company. An area for concern would be the declining sales growth rate over the past few years. A thorough analysis should be done on the industry to determine market shifts and establish whether Home Depot is adequately aligned to ensure growth levels that would sustain profitability. APPENDIX Workings