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The successful integration of distribution centers that lower transaction costs, an expansive product selection through exclusive and proprietary agreements, and the initiation of a quality assurance program positioned Home Depot to earn consistent above-average profits within a highly fragmented retail (home improvement) industry. Accounting Analysis The accounting policies adopted by the Home Depot prove to be in line with it's business strategy. Overall, the Home Depot is very forthcoming with their accounting practices and policies. The pecifically identify three major areas of accounting policy in regards to their specific industry to further their business strategy as it relates to merchandise inventories, self insurance and revenue recognition.

The firm is proactive in divulging accounting policy regarding each of these areas. They specifically address the firm's actions in regards to required GAAP changes and liberally discuss their adoption of certain GAAP in their financial reporting such as their policy regarding the upcoming change in policy for the firm in their treatment of operational leases as opposed to capital leases.

The firm goes as far as to forecast how the change in policy will affect future financial statements in 2004 the notes to their 2003 financial documents. Ratio Analysis Computation of the ratios relevant to the home improvement retail industry shows no significant problems for Home Depot. Home Depot is operating on relatively wide margins compared to its competitors.

Costs have been managed well and debts are being 5 paid more slowly; this does not pose a problem because the average payment time for the industry is much slower than Home Depot.

The sustainable growth rate is quite high compared to Lowe's which can be explained by Home Depot's innovative business strategy. Forecasting Sales growth over the past five years has grown fairly consistently. The growth rate in sales is assumed to continue into the future, with a similar upward trend in future earnings.

Recently, Home Depot has taken on more short term debt, but this should not impact their capital structure significantly. Total assets have been steadily increased over the past five years and that trend is expected to continue.

There is not a large spread between the operating cash flow and earnings, which is a good sign for the quality of accounting information. The growth trend in assets and income and cash flow can be expected to increase because of expansion into other countries, mainly China and Mexico. Valuation Different methods of valuation were used to assess the value of Home Depot.

We have the most faith in the abnormal earnings growth, residual income, and discounted cash flow valuation methods. In the abnormal earnings and residual income model, the stock was overvalued.

In the discounted cash flow method the stock was slightly undervalued. In the method of comparables valuations, the stock was most accurately priced by the P/E method. If modest growth rates are assumed, along with a beta slightly above the market's beta, Home Depot's stock is slightly overvalued.

6 II. Business Summary The Home Depot, Inc. is the world's largest home improvement retailer and the second largest retailer in the United States. Home Depot distinguishes itself as the leader of the retail (home improvement) industry by focusing on sales, service, and execution.

By utilizing this operating strategy Home Depot reported a sales growth of 11. 3% during the 2003 fiscal year earning $64. 8 billion in revenues, up from $58. 2 billion in 2002. The Home Depot, Inc.

has set itself apart from industry competitors by implementing a growth strategy of strengthening its core competencies by offering every customer a unique experience through store modernization, carrying a variety of distinctive merchandise, providing high quality service associates, and expert information technology. Subsidiaries of Home Depot, Inc. rovide specialized services to both the individual homeowner as well as the professional customer. Home Depot has a competitive advantage over other firms in the industry by creating a dimension of tight cost control and providing premium value to customers through merchandise selection and expert service.

Home Depot is currently operating 1, 778 stores in the United States, Canada, and Mexico. The Home Depot, Inc. is in a highly competitive industry that is based on the factors of price, store location, customer service, and depth of merchandise.

Home Depot estimates that its share of the U. S. home improvement industry is approximately 11 percent.

Globally the home improvement industry is approximately at $900 billion offering extraordinary growth opportunities. The Company experienced an increase in comparable store sales of 3. 8% in fiscal 2003 with an average ticket of $51. 15, the highest in company history.

The lawn and garden category was the biggest driver in fiscal 2003 for the boost in store sales. This increase in comparable lawn and garden sales can be tied to firm rivalry in the Southern United 7

States, between Home Depot and Lowe's, where a growing customer base and loyalty is being won or lost as patrons have been affected by three hurricanes within thirty days of each other. Products and Services Home Depot provides a blend of high-quality merchandise for all areas of home improvement. In a highly competitive market Home Depot relies on competitive pricing strategies, service-oriented associates, and supplying a combination of higher-end premium products at a fair value. The Home Depot, Inc.

provides specialized services to the customer market through two main types of stores, Home Depot Stores and EXPO Design Center Stores.

Home Depot Stores sell a wide range of building materials for home improvement, lawn and garden products, and provide a number of valuable services. HD expanded a number of in-store initiatives and programs to increase customer loyalty including: • Professional Business Customer

Initiative: The Company increased the available quantities of products typically purchased by professionals in bulk to provide additional savings to the customer. HD has successfully anchored a position as a cost leader through this initiative of a tight cost control system and low-cost distribution.

• Color Solutions Center: HD provides leading paint brands and proprietary paint matching technology. Appliance Sales: HD provides customers with unique premium appliances manufactured by General Electric, Maytag, and other leading manufactures as well as displaying and stocking the more popular appliances in the store. • Designplace Initiative: Offering an enhanced shopping experience to design customers HD highlights its core competencies with superior product variety and customer service. HD provides personalized service, specially-trained associates, and an expansive merchandise selection.

8 •

Tool Rental Centers: HD rents approximately 225 commercial-quality tools in 12 categories, including saws, floor sanders, generators, gas powered lawn equipment, and plumbing tools to satisfy a broad range of the needs of professional and do it yourself customers. This initiative allows HD to operate under a tight cost control system and emphasize a key success factor of high quality merchandise. EXPO Design Center Stores offer interior design products, such as kitchen and bathroom cabinetry, soft and hard flooring, appliances, window treatments, lighting fixtures, and arrange installation services through qualified independent contractors.

The EXPO Design Center Store focuses on distinguishing itself from other industry competitors by providing a strong value chain network of premium products and accentuating core competencies within the business segment.

Competitors With few direct competitors found within the highly fragmented home improvement industry, Home Depot has differentiated its stores by offering several unique formats to accommodate the needs and interests of customers while offering products at a cost lower than the premium price customers are willing to pay.

Of the 1, 788 stores The Home Depot, Inc. was operating at the end of the second-quarter of fiscal 2004 1, 569 are Home Depot stores, 54 are Expo Design Centers, 11 Home Depot Landscape Supply SM, 5 Home Depot Supply SM, and 2 Home Depot Floor Stores. For this reason The Home Depot, Inc.

has pitted itself against competition outside of its immediate industry, retail (home improvement), and increased the high threat of substitute products. 9 Lowe’s Companies, Inc. (LOW) is the second largest retailer of home improvement products in the world with $33. billion in revenue for the 2003 fiscal year. With low switching costs to customers Lowe’s is Home Depot’s main rival within the industry. Lowe’s serves and specializes in the do-it-yourself (DIY) customers, appliances, lawn and garden, home decor, repair/remodeling, specialty trade contractor, and property management market segments of the home improvement industry.

Lowe’s, as of January 31, 2003, operated 854 stores in 44 states with approximately 94. 7 million square feet of retail selling space.

The company is operating under an aggressive growth strategy focusing much of its future expansion on metro-markets with populations of 500, 000 or more. Lowe’s home improvement warehouse carries over 40, 000 products and each store provides a wide selection of nationally advertised brand name merchandise. Of the thousands of items offered, both in the store and available through its special orders system, Lowe’s merchandise selection supplies both the do-it-yourself (DIY) customer and the commercial business customer with products and merchandise needed to repair, maintenance, and complete construction projects.

Lowe’s sources its products through 7, 000 vendors worldwide, with no single vendor accounting for more than 4% of the total purchases.

The company is not dependent on a single vendor and has alternative competitive distribution access available from suppliers to further increase its opportunities for product quality and gross margin. The company has a strategic alliance with HGTV network that allows it to exclusively run commercials for a substantial portion of the commercial airtime. This is only one of a half dozen media partnership programs employed to build the image and equity of the Lowe’s brand. 0 Sherwin-Williams Company (SHW) generated $5. 4 billion in revenue for the fiscal year ending December 31, 2003 by engaging in the manufacturing, distribution, and sale of coatings and related products to professional, industrial, commercial and retail customers primarily in North and South America.

The company relies heavily on trademarks and trade name recognition, which significantly supplement the sales. The Paint Stores Segment manufactures original equipment manufacturer (OEM) product finishes.

Original equipment manufacturer product finishes are sold to certain shared or dedicated paint stores and by direct outside sales representatives building strong and exclusive relationships with both buyers and suppliers of paint. The company is a leading manufacturer and retailer of paints, coatings and related products to professional, industrial, commercial and retail customers. Sherwin-Williams has a competitive advantage over EXPO Design Centers by sustaining their industry position as the leading manufacturer and retailer of paints. The sustainability of competitive advantage is volatile depending on both product offered and market.

Tractor Supply Company (TSCO) is focused on supplying products for the lifestyle needs of the recreational farmers and ranchers as well as tradesmen and small businesses. The Company has identified a specialized market niche and focuses its product mix on these core customers. The Company utilizes an " everyday low price" strategy and offers exclusive top quality private label products to sustain a strategic advantage over general merchandise, home center, and other specialty stores. Tractor Supply Co. created a uniform store layout to provide maximum sales and operating efficiencies.

The company believes that is has differentiated itself by from " big box" retailers by focusing on the specific needs of a target customer base. By utilizing this 11 strategy TSCO has strengthened its value chain in comparison to Home Depot’s lawn and garden segment. Building Materials Holding Corporation (BHMC) is one of the largest residential construction service companies in the United States with sales in excess of $1 billion. The Company specializes in providing construction services, manufactured building components, and high quality materials to residential builders and contractors.

By targeting professional builders and contractors BHMC has positioned itself to gain high-volume repeat customers. Building Materials Holding Corp.

operates by concentrating on manufacturing and installation services, on-time job-site delivery, and volume purchasing which are not typically offered at smaller consumer-oriented retailers but will become important to sustain a competitive advantage as the “ baby boomer” generation moves into the do-it-for-me (DIFM) segment of the market.

Griffin Land & Nurseries Incorporated (GRIF) is operated by its wholly owned subsidiary, Imperial Nurseries, Inc. The landscape nursery business is extremely fragmented, and the Company believes that its sales volume places it among the 20 largest landscape nursery growers in the industry. Imperial is currently reviewing a number of ways to increase return on assets for its growing operations such as an increase in the percentage of its product sold to retail garden centers. Sales to garden centers generally have more favorable gross margins than those from sales of mass merchandisers.

The Company’s growing operations have been effected by seasonality and increased shipping costs through distribution channels.

Industry Analysis The retail (home improvement) industry is highly fragmented and has few direct competitors for The Home Depot Inc. The Home Depot, Inc. and Lowe's Companies, 12 Inc. dominate the industry, controlling more than 30% of the U.

S. market; Lowe's, to date, remains Home Depot's single direct competitor within the industry. Home Depot, Inc. as several store formats to compete in this highly fragmented industry, the store formats include the traditional Home Depot store, EXPO Design Center store, The Home Depot Supply store, Home Depot Landscape Supply, and The Home Depot Floor Store. The estimated market share holding for Home Depot in the home improvement industry is 11% at end of fiscal year 2003 but because of the fragmented industry measuring the effect of sales against competitors is extremely difficult. The " Five Forces Model" associates the intensity of competition and determines the potential for creating abnormal profits by the firms within the industry.

Rivalry Among Existing Firms The retail (home improvement) industry has an extraordinary opportunity for growth globally. Viewed as once a stagnant market Home Depot has estimated the global home improvement industry to be approximately $900 billion with enormous potential for abnormal profits. Home Depot, Inc. is capitalizing on this by operating 102 Home Depot stores in eight Canadian provinces and 18 Home Depot stores in Mexico. To increase customer base and service levels Home Depot often opens new stores near the edge of market areas currently served by existing stores.

This operating strategy, known as ‘ cannibalization,’ initially has a negative impact on store sales but provides for long-run profitability by increasing customer service levels, gaining incremental sales, and enhancing long-term market penetration.

The retail (home improvement) industry is highly concentrated with few publicly traded direct competitors. Home Depot defines itself through an operating strategy based on core competencies, premium merchandise, and lower costs. 13 Threat of New Entrants The Home Depot, Inc. ffers product category leadership by offering high-end appliances through exclusive agreements with manufacturers, superior quality service by providing free how-to clinics, kiosks enabling customers to identify projects and print step-by-step instructions in the store, and remains a cost leader through tight cost control by offering tool rental centers to customers which offer 225 commercial-quality tool in 12 categories.

Most of the premium merchandise offered in Home Depot is purchased directly through the manufacturer.

Home Depot has formed strategic alliances and exclusive relationships with a number of suppliers to market products giving Home Depot an absolute cost advantage over new entrants. Home depot is dependent upon the timely execution and delivery of products to its stores to maintain an inventory of competitively priced premium products. To compete nationally Home Depot has built central distribution centers to process globally sourced merchandise more efficiently. Transit facilities have effectively lowered the number of distribution centers required in the United States and Canada. Home Depot utilizes 10 transit facilities in the United States.

It is here that Home Depot receives and processes merchandise from manufacturers and then immediately cross-docks it onto trucks for delivery to specific stores. Approximately 40% of the merchandise shipped to the stores was processed through the network of distribution centers and transit facilities with the intent of lowering distribution costs and increasing seamless efficiencies for the end-consumer. Threat of Substitute Products Customers’ willingness to switch is often the critical factor in making the competitive dynamic work. Home Depot maintains a global merchandise program to 14 ource high-quality products directly from overseas manufacturers, which gives the customers an expansive selection of innovative products and better value, while enhancing gross margin.

Outside, smaller, retailers have the ability to target a specific need and interest of the consumer and to provide dedicated service and knowledge to an individual customer. Strategic alliances from manufacturers for exclusive product distribution in dedicated home improvement stores, such as Sherwin-Williams with Dutch Boy paint, curtails the mass utilization of Home Depot’s paint mixing stations, which represent an integral part of the store modernization.

The Company offers a variety of installation services expanding its market share based on the uniqueness of the Home Depot’s core competencies and value chain. Home Depot has recognized an opportunity for increased market share by examining “ mega trends” in the growth of the Hispanic population and the aging population. Eighty-five percent of the nation’s homes were built prior to 1980 and will be in need of frequent repair heightening the future opportunity of the “ do it for me” sector of Home Depot customers.

Services provided by Home Depot include the installation of carpeting, hard flooring, cabinets, water heaters, and solid surface countertops through qualified independent contractors in the U.

S. and Canada, lending itself out as a unique service provider to the consumer. Bargaining Power of Buyers Home Depot buys store merchandise from vendors located throughout the world and is not dependent on any single vendor establishing the Company’s bargaining power, relative to that of the supplier’s, high.

Merchandise is bought directly through the manufacturer and shipped to stores through transit facilities.

Home Depot employs a global sourcing merchandising program into its core strategy to source high-quality 15 products directly from overseas manufacturers. Product development associates travel internationally to identify opportunities to purchase items directly for Company stores eliminating the “ middleman” costs allowing Home Depot to develop a price sensitive product selection for the consumer and increase the Company’s gross margin.

HD has established strategic alliances with certain suppliers to market products under a number of proprietary and exclusive brands. Home Depot has two sourcing offices located in Shanghai and Shenzhen, China, and has a product development merchant located in Bonn, Germany. These assignments allow HD to advance product features and quality, to import products not currently being offered to customers and furthers the operating strategy of offering premium products at a lower cost than would be available through a third-party vendor.

Bargaining Power of Suppliers Home Depot’s suppliers are numerous with no supplier playing a major contributory role critical to the Company’s business. HD currently source products from more than 500 factories in approximately 40 countries. The Home Depot, Inc. has initiated a quality assurance program to measure factors such as product quality, timely shipments, and fill rate of all vendor performance. The quality assurance program has established a strict standard to which product performance must adhere.

Product testing prior to purchase ensures the compliance of product equirements with HD specific policies. Home Depot systematically evaluates product quality and factory performance by conducting inspections at the factory to assure continued compliance with HD’s product requirements. The retail (home improvement) industry allows Home Depot to maintain considerable power over vendors because of their large buying power and relatively low switching costs. 16 Competitive Strategy The Home Depot, Inc.

has positioned itself within the industry based on a strategy of cost leadership.

This operating strategy allows the Company to earn above-average profitability by dictating prices from suppliers lowering input costs and minimizing distribution transactions eliminating the “ middleman. ” HD has developed a tight-cost control system through quality assurance program that monitors vendor compliance with Home Depot requirements. Home Depot has positioned itself for future business by generating distinctive store formats to accommodate a diversified customer base allowing HD to compete in niche markets such as lawn and garden and the private contracting of home installation.

Home Depot’s core competencies are centered upon the timely execution and delivery of products to its stores to consistently providing an inventory of competitively priced premium products. Achieving and Sustaining Competitive Advantage Home Depot must find a viable way to introduce new business segments and services into the company structure while maintaining the image of comparable highquality value merchandise and service.

The sustainability of Home Depot’s competitive advantage is based on the Company’s ability to control cost at the source while providing superior product variety and customer service.

Key success factors for The Home Depot, Inc. are the stability of costs and availability of sourcing channels, lowering input costs through monitoring of vendors, and concurrently escalating efficiency at all levels for the end-consumer. Home Depot currently has both the resources and capabilities to maintain these key success factors. Improved inventory management resulted in lower shrink levels for imported products, and enhanced service associates contributed to an increase in average ticket growth in every selling category, with an average of 8. 2 percent, from 17 $4.

13, to $54. 3, in the second quarter of fiscal 2003. Fluctuations in the U. S. economy, the Company's ability to retain highly qualified associates, unforeseeable and unusual weather conditions, and the impact of competition remain deterrents to maintain a profitable going-concern for The Home Depot, Inc.

Home Depot's value chain is expanding to accommodate a balanced consortium of customers. The value chain includes the introduction of paint centers, tool rental centers, trained associates, increases in technology, and store modernization customizing formats to the needs of the market.

Applying The Cost Competitive Strategy Home Depot has maintained a competitive strategy to date through the integration of low transaction costs, premium quality merchandise, and specialized services to meet the demand of growing niche markets. HD has developed a growth strategy anchored in continuously assessing opportunities to increase customer loyalty, increase sales, and further market penetration. The Home Depot, Inc.

grew service revenues by approximately 27 percent to $883 million in fiscal 2003.

In fiscal year 2003, HD acquired White Cap Construction Supply, Inc. , to operate 74 Pro distribution branches across the country. Home Depot's strategy remains strengthening its core competencies through quality assurance and consistent competitive prices. Expansion of tool rental centers to 925 stores in the United States, the purchase of 20 Home Mart stores in Mexico, and the operation of 1, 788 stores in the U.

S. are attributed to Home Depot's key success factors and competitive cost strategy. 18 III. Accounting Analysis The Home Depot, Inc.

Accounting Policies The retail industry, in general, presents a very competitive market with high price competition and low product differentiation. Although almost any retailer, from supermarkets to superstores, can offer home improvement items at a competitive price, the home improvement industry currently provides a great opportunity for differentiation in regards to the types of services home improvement retailers offer.

To successfully maximize sales and increase revenues in the home improvement industry, retailers such as Home Depot must uccessfully combine product variety, quality and price and specialized services.

As discussed earlier, Home Depot has adopted a business strategy based on these key factors. Consequently, as we look at Home Depot's overall financial results, it is necessary to focus on key accounting policies adopted by the company to measure critical factors and risks. In the " Management's Discussion and Analysis of Results of Operations and Financial Condition" of The Home Depot, Inc 2003 Annual Report (www. homedepot. om), management identified three major areas as areas of critical accounting policy and discussed the adoption of four different accounting pronouncements.

In addition to the four recently adopted accounting pronouncements identified in the management's discussion, The Home Depot identified four other major accounting policy changes in it's " Notes to Consolidated Financial Statements". Specifically, The Home Depot adopted four different accounting pronouncements in regards to service revenue recognition, vendor allowances, goodwill amortization and stock based compensation.

The three critical accounting policies, as identified by The 19 Home Depot management refer to the treatment of merchandise inventories, self insurance and revenue recognition. Merchandise Inventory policy is specifically addressed by The Home Depot management in " Management's Discussion and Analysis of Results of Operations and Financial Condition" and is assessed in two different ways. Approximately 93% of total inventory is valued at the lower of cost or market utilizing FIFO under the retail inventory method with the other 7% valued under the cost method.

The Notes section of the Financial Statements accounts for the two different methods.

According to the Notes, the 7% of inventory valued under the cost method was due to inventory policy of certain subsidiaries and distribution centers. In addition, The Home Depot, Inc. takes a physical inventory count on a regular basis at each store to verify that inventory amounts in the merchandise inventory section of the Consolidated Financial Statements are accurate. Lastly, in regards to merchandise inventory, the company does account for possible inventory shrinkage or swell based on historical results and industry trends.

Self Insurance accounting policy for Home Depot addresses it's treatment of " losses related to general liability, product liability, workers' compensation and medical claims". The total liability is estimated on the total cost incurred as of the specific balance sheet date and is not discounted. The estimate is based on " historical data and actuarial estimates". The company also explains in it's Management Discussion that they ensure estimates of liability are as accurate as possible by having both management and third-party actuaries review the estimates on a quarterly basis.

Revenue Recognition is the third critical accounting policy identified by The Home Depot management.

Revenue recognition at the Home Depot follows the industry 20 norm of recognizing revenue when the customer takes possession of the merchandise or, if a customer makes payment prior to take ownership of the merchandise, Home Depot records the sale as Deferred Revenue on the balance sheet until the sale is finalized when the customer takes possession of the paid merchandise.