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Moving Out

Behind Nardelli's Abrupt Exit

Amid a Pay Dispute, Home Depot's Chief Faced Board Tensions

By JOANN S. LUBLIN, ANN ZIMMERMAN and CHAD TERHUNE
 January 4, 2007; Page A1

Last June, Home Depot Inc.'s board compensation committee decided to review the most contentious aspect of Chairman and Chief Executive Robert Nardelli's tenure: his pay package.

Mr. Nardelli submitted a one-page list of perks he was willing to drop, including personal use of the six corporate jets, according to one person involved in the matter. But he dug in his heels about his guaranteed \$3 million annual bonus and his hefty supplemental pension arrangement.

CHANGE AT THE TOP

- **The News:** After negotiating with Home Depot's board, Robert Nardelli resigned as chairman and chief executive.
- **The Background:** Under his leadership, the retailer boosted sales, but his high pay and autocratic style drew criticism.
- **What's Next:** His successor, Frank Blake, must try to repair relations with shareholders. ([See related article](#))

"I know that things have to

change," he said, according to a second person familiar with the situation.

Yesterday, Home Depot, the world's third-largest retailer by sales, announced a big change: Mr. Nardelli was leaving the company, taking an exit package valued at about \$210 million, including \$20 million in cash severance.

Mr. Nardelli failed to reignite Home Depot's slowing sales and sagging stock price. Other problems compounded his troubles. His autocratic style clashed with a freewheeling culture fostered by the company's founders. His aggressive handling of the company's most recent annual meeting, where no outside directors were on hand and limits were set on shareholders' questions, outraged some investors. And the pay package that had lured

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A ROUGH 2006

Home Depot came under fire last year for governance issues and the size of Nardelli's compensation package.

January 2006: Plans to cut retail-store openings by nearly half over the next five years, facing fewer places for U.S. expansion and a stagnant stock price.

April: Directors come under criticism for approving more than \$115 million in compensation for Nardelli since he took the helm, while the company's shares declined sharply.

May: Acknowledges it botched the handling of its annual meeting, which none of the company's outside board members attended. At least 30% of shareholder votes were withheld from 10 of the 11 directors, including Nardelli.

June: Admits to five instances in which directors had retroactively approved stock-option grants.

him to the company became a lightning rod for criticism that the board felt compelled to address.

Mr. Nardelli grew tired of the constant battering he was taking in the press and on Wall Street, according to a longtime acquaintance, and resented being blamed for Home Depot's share price when other chief executives, such as [General Electric](#) Co.'s Jeffrey Immelt, escaped such criticism.

Board members agreed over the past few weeks that Mr. Nardelli should step down, according to the second person familiar with the events. Mr. Nardelli, 58 years old, reached agreement with the board in a meeting Tuesday in Dallas, far from the company's Atlanta headquarters, "There was no smoking gun," this person says. "The board and Bob reached agreement that it was time for a change."

Pay was a central factor in luring Mr. Nardelli to Home Depot from GE, after he lost a three-man race to become CEO there, and it loomed large as he left. Mr. Nardelli received compensation valued at more than \$240 million over his tenure at Home Depot, with a hefty chunk of it in stock options. In the fiscal year ended Jan. 31, 2006, the board awarded him a \$7 million bonus and about \$14.7 million worth of restricted shares.

In December, activist investor Relational Investors LLC began pushing Home Depot to establish a special committee to review the company's strategic direction and management performance, and to explore possible alternatives, including a sale of the company. It also alerted Home Depot it planned to nominate at least two directors at the company's next annual meeting, in May.

Yesterday, Barney Frank (D., Mass.), chairman designate of House Financial Services Committee, lambasted Mr. Nardelli's exit package, citing the rise of Home Depot shares on the news. "Some defenders of CEO pay argue that CEOs are rewarded for increasing the stock or the overall value of the company, but judging by today's market reaction, Mr. Nardelli's contribution to raising Home Depot's stock value consists of quitting and receiving hundreds of millions of dollars to do so," he said in a statement. The stock yesterday rose 91 cents, or 2.3%, to close at \$41.07 a share.

Mr. Nardelli, who could not be reached for comment for this story, will be replaced by Frank Blake, 57, Home Depot's vice chairman and executive vice president, who headed strategic initiatives, among other areas. The new CEO's compensation package is still being determined, said a Home Depot spokesman.

Tough Times

Mr. Nardelli faced tough times for big retailers that have limited options for diversifying. Home Depot and Wal-Mart Stores Inc. ratcheted down their growth projections because new stores were

August: Adopts a majority-vote standard for election of board directors, making it more difficult for disgruntled shareholders to have an effect by registering a "withheld" vote.

September: The lead director on the compensation committee defends Nardelli's pay and performance but said directors are reviewing policies in light of investor concerns. Nardelli says he has no intention of resigning.

December: An internal investigation finds that the company routinely backdated stock options from 1981 to 2000, and as a result it understated compensation expense by \$200 million.

Source: *WSJ.com* research

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COMPANIES

Dow Jones, Reuters

[Home Depot Inc. \(HD\)](#)

PRICE	40.17
CHANGE	0.26
	4:01p.m.

[General Electric Co. \(GE\)](#)

PRICE	36.03
CHANGE	-0.16
	4:03p.m.

[Lowe's Cos. \(LOW\)](#)

PRICE	32.50
CHANGE	-0.17
	4:04p.m.

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stealing too much business from existing ones. Wall Street no longer views these retailers as growth stories, and their stock prices have languished.

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WSJ reporter Joann Lublin speaks to Dow Jones Online's Ed Crane about the resignation of Home Depot CEO Robert Nardelli. Plus, **WSJ's Alan Murray** and the CNBC "Squawk Box" team react.

Home Depot's share price fell 8% during Mr. Nardelli tenure, which began in December 2000. The company is locked in a fierce battle with Lowe's, which boasts newer, brighter stores and a better image with many shoppers. Lowe's stock has risen 188% in the past six years.

When he came to Home Depot, Mr. Nardelli had run mines and locomotive factories for General Electric but lacked retail experience. Short, balding, aggressive and hard-working, he was known at GE as a great manufacturing executive, and he pushed GE Power to record profits during the 1990s. But in 2000, he was passed over to succeed Chief Executive John F. Welch Jr., a decision that took him by surprise, according to people with knowledge of those events.

At that time, the number of high-growth markets in the U.S. without Home Depot branches was dwindling fast. New stores increasingly prospered only by stealing business from nearby Home Depots. The company was struggling to maintain earnings growth of 25% annually, a target it had hit with ease for years. The company shocked investors in October 2000 with a profit warning that sent the stock tumbling 28% in one day.

That setback spurred the board to recruit Mr. Nardelli to replace Chief Executive Arthur Blank, one of Home Depot's founders and inspirational leaders.

WHO'S WHO

Biographical information on Home Depot's former and current chiefs

Bob Nardelli, 58 years old

Position: Former CEO of Home Depot.

Career: Nardelli began his career at General Electric in 1971 and advanced through a series of leadership positions. In 1988, he left GE to join Case Corp. in Racine, Wis. Nardelli returned to GE in 1991 and was ultimately named president and CEO of GE Power Systems.

Education: Bachelor's degree in business, Western Illinois University. M.B.A., University of Louisville.

Frank Blake, 57

Position: New chief executive and chairman of Home Depot. Formerly served as vice chairman of Home Depot's board. He joined Home Depot in 2002 as executive vice president, business development and corporate operations.

Career: Blake previously served as deputy secretary for the Department of Energy. Before that, he served in a variety of executive roles at GE. Blake also served as general counsel for the U.S. Environmental Protection Agency and deputy counsel to the elder George Bush when he was vice president.

Education: Bachelors degree, Harvard. J.D., Columbia University School of Law.

Source: Associated Press

Mr. Nardelli set out to stamp out the decentralized "cowboy culture" of the company. Home Depot's founders had allowed store managers to run their stores as autonomous fiefdoms with little regard for uniformity or efficiency. This entrepreneurial spirit had made Home Depot one of the hottest growth stocks ever, and its store count doubled nearly every four years. Its surging stock price made hundreds of early employees millionaires.

Mr. Nardelli's management style was a stark contrast to that of Home Depot's paternalistic founders, Bernard Marcus and Mr. Blank, who were treated like heroes during store tours and personally tutored employees on customer service. Mr. Nardelli often appeared uncomfortable donning the retailer's trademark orange apron and dealing with front-line employees one-on-one.

The pressure to grow intensified in the face of extraordinary returns from [Lowe's](#), which outperformed Home Depot in same-store sales. Lowe's often chose to build across the street from aging Home Depot outlets. It outpaced Home Depot in appliance sales by giving the merchandise more space and by training dedicated salespeople. Lowe's attracted more female shoppers with brighter, cleaner stores. Home Depot now mimics many of these Lowe's techniques.

Mr. Nardelli moved to cut back on higher-paid full-time employees with experience as plumbers or handymen, and to rely more on part-time workers with less experience answering home-improvement questions from customers. Frequently, Mr. Nardelli found himself fending off

questions about deteriorating customer service and about whether cost-cutting was the cause of that. Every few months, Home Depot management would roll out another program aimed at improving customer service, from employee bonuses to customer call buttons. But none appeared to have any lasting effect.

Looking for another engine for growth, Mr. Nardelli decided to expand into the building-supply business, spending more than \$6 billion over the past two years to acquire more than 25 wholesale suppliers. Their customers range from utilities needing poles to builders looking for lumber to cities in need of fire hydrants.

But selling to the construction trades is a much different business from mass-merchandising tools and paints. Contractors rely on longstanding relationships with suppliers and trained salespeople. Many associate the Home Depot brand with do-it-yourselfers and soccer moms pushing shopping carts, and avoid the stores.

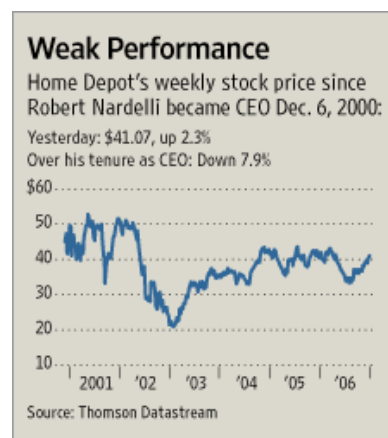
Some analysts and investors worried that Home Depot was snapping up supply businesses with lower profit margins than Home Depot's existing stores. Mr. Nardelli took criticism for not investing more money into renovating Home Depot's aging stores and for not hiring more seasoned employees capable of offering better home-improvement advice.

At Home Depot's annual meeting last May, with disappointment over shareholder returns mounting, Mr. Nardelli ignited a firestorm by refusing to respond to investor concerns about his hefty compensation and for enforcing a strict time limit on comments from the floor. The same month, the company surprised investors with a decision that it would no longer report quarterly same-store sales, a key industry benchmark, arguing that the expansion into building supplies had reduced the importance of that measure. Mr. Nardelli was forced to reverse that decision the following quarter.

Swept Up in Scandal

To make matters worse, Home Depot was also swept up in the scandal over backdated stock options. In mid-December, it wrapped up an internal investigation that concluded that the company routinely backdated stock options for 20 years, and as a result understated compensation expense by \$200 million. The practice started in 1981 and ended just before the arrival of Mr. Nardelli. With fiscal 2006 sales of \$81.5 billion, the home-improvement retailer is one of the largest companies to admit to backdating stock options. During the previous two decades, the company was run by founders Mr. Marcus and Mr. Blank, but neither founder received stock options. The company wouldn't say who did receive the awards and who made the decision to backdate them.

As criticism over his performance and pay mounted, Mr. Nardelli defended his record. Home Depot, he frequently pointed out, had posted earnings-per-share growth in excess of 20% for four consecutive years, one of only two companies in the Dow Jones Industrial Average to do so.



"There is hardly a financial metric you can point to where we haven't made progress," Mr. Nardelli said in an interview last May. "We are going through an enormous transformation. Sometimes transformation is unsettling, not only internally but also externally to Wall Street."

By late November, the board's review of Mr. Nardelli's pay package was coming to a head.

Home Depot was paying Mr. Nardelli even more than the amount promised under his contract, thanks in part to bonuses the board awarded him due to growth of sales and diluted earnings per share. A pay consultant retained by the compensation committee concluded that he was making more than his industry peers, according to a person familiar

with the situation. In discussions with the committee, Mr. Nardelli had agreed to forgo some perks, but not his guaranteed bonus or supplemental pension.

His demands were a problem for some board members, this person says. Directors would have been happier if he had been more "willing to make concessions on his pay package," says the acquaintance of his. But Mr. Nardelli felt further concessions would represent an admission that he didn't deserve what he had earned, the acquaintance says.

Board members realized that if they stuck strictly to the terms of Mr. Nardelli's written contract and did not give him anything more, his compensation was likely to be lower in fiscal 2006 than in 2005, according to the person familiar with the matter. For that reason, the board decided in November not to try to amend the contract. The directors tentatively agreed that Mr. Nardelli's fiscal 2006 bonus would be less than in 2005, but no final decision was reached, this person says.

The friction over pay was a factor in his departure, this person says. Directors met informally several times late last year prior to their final meeting on Tuesday with Mr. Nardelli.

Ralph Whitworth, co-founder of Relational Investors, says Mr. Nardelli's departure won't deter his firm from seeking board representation. "This paves the way for a review of the company's strategy," Mr. Whitworth says. "This wasn't about who, but about what -- about a strategy that was way off track."

The board briefly discussed, but did not pursue, one alternative -- going private, according to two people familiar with the matter.

Mr. Nardelli's successor, Mr. Blake, is a former GE colleague of his. Mr. Blake offered the advantage of being an established insider. That spared Home Depot a protracted period of uncertainty during an external search, and eliminated the need for it to dole out any "make whole" payments to anyone leaving another company, as Mr. Nardelli had received.

Directors are still working out final details of Mr. Blake's pay deal. They already have decided that Mr. Blake won't have an employment contract as CEO, the second person familiar with the matter says, and that elements of his pay package will resemble "what shareholders have been asking for."

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