Home Depot (HD)

FORECAST REDUCTION

A New Dawn

After sitting down with new CEO Frank Blake on Friday, we came away encouraged that he will lead the company in the right direction. While his appointment does not mean all HD associates immediately will be engaged and focused on improving the company after a period of lethargy, we believe Blake's mild-mannered personality combined with his desire to focus on the bigger picture to improve the shopping experience while having fun will be well-received by associates, customers and shareholders alike.

That said, the company is caught in a tough bind near term. It faces a macro environment that likely will stay weak all year and suffers from deficient systems, poor store morale, underinvestment in its infrastructure and a weakened retail management team. It still has the highest volume per store in the sector and has great cash flow and a strong balance sheet but that won't protect its operations without investment. Near term, we hope that the company ignores the impact of these investments on the bottom line, something Mr. Nardelli did not do and invests in the systems and people needed to compete. Even if they do, as we see with all turnarounds, the near term will be rough and likely result in lower earnings than investors expect and we are lowering our already below-consensus 2007 EPS estimate from $2.84 to $2.70.

Said another way, we would be looking for downside to earnings regardless of the direction of investment. If one is more confident on the macro outlook than we are, LOW appears to be the better name and should also gain near term from the disruption within HD. Specific to HD, we see the stock likely trading in the near-term on investor sentiment toward Blake's changes than actual results, and already reflects a degree of improved sentiment in our view. Indeed, we expect soft Q4 results to be reported next month, but the investor conference at the end of the month when Blake shares more details will be most important.

Financial and valuation metrics

<table>
<thead>
<tr>
<th>Year</th>
<th>1/06A</th>
<th>1/07E</th>
<th>1/08E</th>
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</thead>
<tbody>
<tr>
<td>EPS (CS adj., US$)</td>
<td>2.72</td>
<td>2.84</td>
<td>2.70</td>
</tr>
<tr>
<td>Prev. EPS (US$)</td>
<td>14.8</td>
<td>14.1</td>
<td>14.8</td>
</tr>
<tr>
<td>P/E (x)</td>
<td>82.5</td>
<td>90.6</td>
<td>99.3</td>
</tr>
<tr>
<td>Revenue (US$ m)</td>
<td>81,511.0</td>
<td>90,766.0</td>
<td>92,420.4</td>
</tr>
<tr>
<td>EBITDA (US$ m)</td>
<td>10,940.0</td>
<td>11,605.3</td>
<td>10,987.7</td>
</tr>
<tr>
<td>OCFPS (US$)</td>
<td>3.02</td>
<td>3.50</td>
<td>4.14</td>
</tr>
<tr>
<td>P/OCF (x)</td>
<td>13.4</td>
<td>11.5</td>
<td>9.7</td>
</tr>
<tr>
<td>EV/EBITDA (current)</td>
<td>8.2</td>
<td>8.3</td>
<td>8.8</td>
</tr>
<tr>
<td>Net debt (1/06A, US$ m)</td>
<td>3,292.0</td>
<td>9,934.7</td>
<td>10,191.5</td>
</tr>
<tr>
<td>ROIC</td>
<td>18.6%</td>
<td>15.9%</td>
<td>13.6%</td>
</tr>
</tbody>
</table>

Share price performance

Financial and valuation metrics

- EPS (CS adj., US$)
- Prev. EPS (US$)
- P/E (x)
- Revenue (US$ m)
- EBITDA (US$ m)
- OCFPS (US$)
- P/OCF (x)
- EV/EBITDA (current)
- Net debt (1/06A, US$ m)
- ROIC

Quarterly EPS

<table>
<thead>
<tr>
<th>Year</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
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</thead>
<tbody>
<tr>
<td>2006A</td>
<td>0.57</td>
<td>0.82</td>
<td>0.72</td>
<td>0.60</td>
</tr>
<tr>
<td>2007E</td>
<td>0.70</td>
<td>0.90</td>
<td>0.73</td>
<td>0.50</td>
</tr>
</tbody>
</table>

On 01/12/07 the S&P 500 index closed at 1,430.73

Source: Company data, Credit Suisse estimates

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Home Depot's investments will come in labor and store appearance, as well as systems/logistics. In our view, these are critical investments that Home Depot needs to make to emerge from the macro slowdown as a viable competitor against Lowe’s, and should extend significantly beyond the $350mm commitment in 2H06. With that in mind, the stock likely will trade more on investor sentiment toward Blake's changes than actual results in the near-term, and already reflects a degree of improved sentiment in our view. Indeed, we expect soft Q4 results to be reported next month, but the investor conference at the end of the month when Blake shares more details will be most important.

The cornerstone of Blake's plan is to simplify the business, an appropriate shift from the more mico-managed Nardelli days in our view. His four priorities as he steps into his new role include taking care of associates to let them know how important they are, bringing back the entrepreneurial spirit, increasing decision-making speed and action by breaking down silos and engaging in two-way communication through the organization.

Progress in 2007 will be marked against the goals Blake sets forth at the February analyst meeting, but should also be visible in the stores. Until we see evidence that the tide is turning in the store-level experience to draw in shoppers, we remain Neutral on shares.
What to Expect in 2007 from Home Depot

While we do expect sea changes under Blake, we think he will be taking some significant steps. Blake has five priorities for 2007:

- **Engage associates**—Modify how hours are allocated to stores, to training, to tasking. Give store managers and associates more authority to be entrepreneurs to do what is best for the customer, rather than being forced to do things by strict company policy to hit short-term targets. Store managers will have more authority on the level and allocation of labor hours will not be held to as many metrics (e.g., how many extended service plans are sold) to focus on the bigger picture goal of sales and profitability. Store managers will get back some of the entrepreneurial responsibilities.

- **Improve store appearance**—Invest more to remove clutter and improve appearance of stores, following stepped up investments in 2H06.

- **Add product excitement**—Build a process to increase innovative products and compelling values. Price is not the issue. Possibly reduce distraction from non-core categories (flat screen TV sales for Christmas that did not meet expectations).

- **Improve in-stocks**—Better align Retail and HD Supply supply chain to improve assortments, and most importantly, in stocks. Leverage technology to reduce touch points for inventory ordering (e.g., inventory management associates). HD will act as quickly as possible to improve in-stocks, under the direction of Mark Holifield from ODP. Eventually, technology should enable the company to take costs out of the distribution process as well.

- **“Own the Pro”**—Break down the silos between Retail and Supply sourcing, category management and pricing are done enter-rise wide. Be able to serve the Pro inside and outside of the orange box (e.g., order job lot quantities at the store and have them delivered from Supply warehouse to job site).

In addition to these priorities, we also expect the following:

- **Hire senior retail talent**—Blake acknowledges the gap in senior retail talent and we would expect him to fill in that gap this year, as well as make other senior management additions.

- **Modify services business**—Blake recognizes the pressures that the services business can exert on the stores in terms of staffing, offering, order management and follow-through. He will look for better ways to execute in services that do not impair store operations.

**Slow growth in core?** As the company continues to cannibalize sales, it may dial back the core growth plan a bit. The current projection is 3-5% core US square footage growth, with a boost to total retail growth from other formats/channels (e.g., Internet, convenience stores). Pro, a division we believe holds much promise, should maintain its growth trajectory, though management may decide to hold off on a major acquisition as it works to better integrate the division with retail.

**Continue leveraging the balance sheet**—Blake recognizes there is significant opportunity to continue to lever the balance sheet and return capital to shareholders, even in the face of stepped up investments. We expect higher leverage this year.

**Expect consensus estimates to come down for 2007.** We are lowering our 2007 EPS estimate from $2.84 to $2.70 vs. consensus of $2.91. We model mid-single digit negative comps, 10 bps of gross margin deterioration, 80 bps of SG&A deleverage and what may prove to be conservative 45 million share count reduction. We expect the macro environment to continue to pressure sales, possibly with more softness in
HD Supply than anticipated. Slower sales combined with very significant investments will pressure earnings in our view.

**Near-Term Weakness Persists**

Near-term, we believe soft continues to be soft, and we maintain our mid-high negative single digit comp estimate. Some elements to help drive traffic and comps in Q4, such as flat screen TVs, appear to have fallen short of projections and that inventory will need to be cleared at weak margins. Meanwhile, unseasonably mild weather has likely led to lower than expected demand for high-ticket products such as snow blowers. On the other hand, other merchandise bets for the quarter, such as increased Christmas-related decorations, appear to have been better than expected.

On the Pro side, we believe the soft housing market is having a stronger than anticipated negative impact on the top line. While that weakness is partially being offset by still favorable trends in commercial construction, we believe organic growth is running flat to low single digits.

We maintain our $0.50 4Q06 EPS estimate vs. consensus of $0.51.
Companies Mentioned  
_Price as of 12 Jan 07_  
Home Depot (HD, $40.11, NEUTRAL, TP $37.00, UNDERWEIGHT)  
Lowe's (LOW, $33.06, NEUTRAL, TP $33.00, UNDERWEIGHT)

Disclosure Appendix

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*See the Companies Mentioned section for full company names.*

3-Year Price, Target Price and Rating Change History Chart for HD

<table>
<thead>
<tr>
<th>Date</th>
<th>Closing Price</th>
<th>Target Price</th>
<th>Rating</th>
<th>Initiation/Assumption</th>
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<td></td>
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<tr>
<td>2/25/05</td>
<td>40.58</td>
<td>50</td>
<td>OUTPERFORM</td>
<td>X</td>
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<tr>
<td>6/22/05</td>
<td>39.7</td>
<td>50</td>
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<tr>
<td>6/28/06</td>
<td>36.16</td>
<td>48</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8/4/06</td>
<td>34.71</td>
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<td>9/18/06</td>
<td>36.58</td>
<td>37</td>
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<th>Outperform/Buy*</th>
<th>Neutral/Hold*</th>
<th>Underperform/Sell*</th>
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<td></td>
<td>39%</td>
<td>43%</td>
<td>15%</td>
<td>3%</td>
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<td></td>
<td>(59% banking clients)</td>
<td>(56% banking clients)</td>
<td>(51% banking clients)</td>
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*For purposes of the NYSE and NASD ratings distribution disclosure requirements, our stock ratings of Outperform, Neutral, and Underperform most closely correspond to Buy, Hold, and Sell, respectively; however, the meanings are not the same, as our stock ratings are determined on a relative basis. (Please refer to definitions above.) An investor's decision to buy or sell a security should be based on investment objectives, current holdings, and other individual factors.

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**Price Target:** (12 months) for (HD)

**Method:** Our $37 target price for HD is 13.7x 2007E EPS of $2.70. We believe HD should be valued at a multiple about in line with its growth rate with a slight discount for macro concerns, in line with other hardline retailers.

**Risks:** Investing in retail stocks entails certain risks, including changes in consumer spending and its components, retail industry competition, and general market risk. Risks specific to HD achieving our $37 price target include faster or slower than expected improvement in the housing market and an LBO.

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