Moving Out

Behind Nardelli's Abrupt Exit

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

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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.

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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.

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

Home Depot's share price fell 8% during Mr. Nardelli's 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.

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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