Home Depot (HD)

Updated August 18th, 2018 by Josh Arnold

Key Metrics

Current Price:	$196	**5 Year CAGR Estimate:**	9.5%	**Volatility Percentile:**	20.0%
Fair Value Price:	$172	**5 Year Growth Estimate:**	10.0%	**Momentum Percentile:**	77.9%
% Fair Value:	114%	**5 Year Valuation Multiple Estimate:**	-2.6%	**Valuation Percentile:**	39.2%
Dividend Yield:	2.1%	**5 Year Price Target**	$277	**Total Return Percentile:**	63.7%

Overview & Current Events

Home Depot was founded in 1978 and since that time has grown into a juggernaut retailer with almost 2,300 stores in the US, Canada and Mexico that generate over $100 billion in annual revenue. The stock has a market value of $226 billion, making it one of the larger companies by market capitalization in the US.

Home Depot's Q2 results were reported on 8/14/18 and were very strong once again. Total revenue rose 8.4% as it enjoyed a massive 8.1% comp sales gain in the US. Gains were broad-based as traffic accounted for 3.1% of the gain while the balance of 5% was from a higher average ticket amount. Earnings-per-share rose 36% against last year's Q2 thanks to higher sales, operating leverage, and a lower tax rate. The company slightly increased its sales guidance for the year but our estimate of $9.50 in earnings-per-share remains unchanged, despite the outstanding Q2 report.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$1.78	$1.66	$2.03	$2.47	$3.10	$3.76	$4.56	$5.34	$6.45	$7.46	***$9.50***	***$15.30***
DPS	$0.90	$0.90	$0.95	$1.04	$1.16	$1.56	$1.88	$2.36	$2.76	$3.56	***$4.12***	***$6.00***

Home Depot's earnings momentum has been enormous in the past decade as it has been able to fully capitalize on the housing and construction boom that ensued following the Great Recession. A strong, continuous tailwind from new construction as well as homeowners continuing to spend on improvements for existing housing have fueled its meteoric rise. With interest rates rising and home prices at or near pre-crisis peaks, these tailwinds should remain intact as it becomes ever more expensive for homeowners to move. We therefore see five-year annual earnings growth of 10%, consisting of a minimal amount of new stores, comp sales in the mid-single digits, a low single digit tailwind from buybacks and a steady, low single digit tailwind from operating margin improvements, per management guidance. Home Depot's growth catalysts are still intact, and we see a continuation of its very strong performance in the years to come.

In addition, the company's streak of meaningful dividend growth should continue as we see the payout rising more slowly than earnings, reaching $6 per share in five years. Home Depot is not an income stock with its low-2% yield, but dividend growth investors should delight in its payout growth prospects. Further, as it matures it may institute a higher payout ratio target for the dividend, further boosting its dividend growth prospects, but that is not our base case.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	14.3	15.3	15.6	15.0	17.9	20.2	19.1	22.1	20.3	21.6	***20.6***	***18.1***
Avg. Yld.	3.5%	3.5%	3.0%	2.8%	2.1%	2.1%	2.2%	2.0%	2.1%	2.2%	***2.1%***	***2.2%***

Home Depot's price-to-earnings multiple has moved up substantially in recent years as its earnings growth rates have moved much higher. Indeed, its 10-year price-to-earnings multiple average of 18.1 is much lower than it has been in the past five years as investors have bid up the shares on improved, sustained growth. We see the valuation drifting back towards the historical average over time, meaning a 2.6% headwind to total returns. Home Depot's sheer size means its growth will need to slow at some point but as of now, that looks to be some time in the future. The yield should remain in the low-2% range despite strong dividend growth as the stock will continue to move up on higher earnings. Home

Depot will therefore continue to represent a strong dividend growth stock, but it will not have an income stock yield until earnings growth slows down.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	36.5%	36.4%	33.0%	33.1%	32.5%	32.8%	32.4%	32.1%	32.0%	32.0%	***32.0%***	***32.0%***
Debt/A	60%	57%	53%	53%	56%	57%	69%	77%	85%	90%	***90%***	***85%***
Int. Cov.	11.8	7.0	7.1	11.3	11.3	12.8	13.1	21.9	15.9	14.4	***16.0***	***18.0***
Payout	51%	54%	47%	42%	37%	42%	41%	44%	43%	48%	***43%***	***39%***
Std. Dev.	43.6%	37.1%	26.2%	23.1%	15.6%	14.3%	16.6%	13.0%	18.5%	13.5%	***18.0%***	***22.1%***

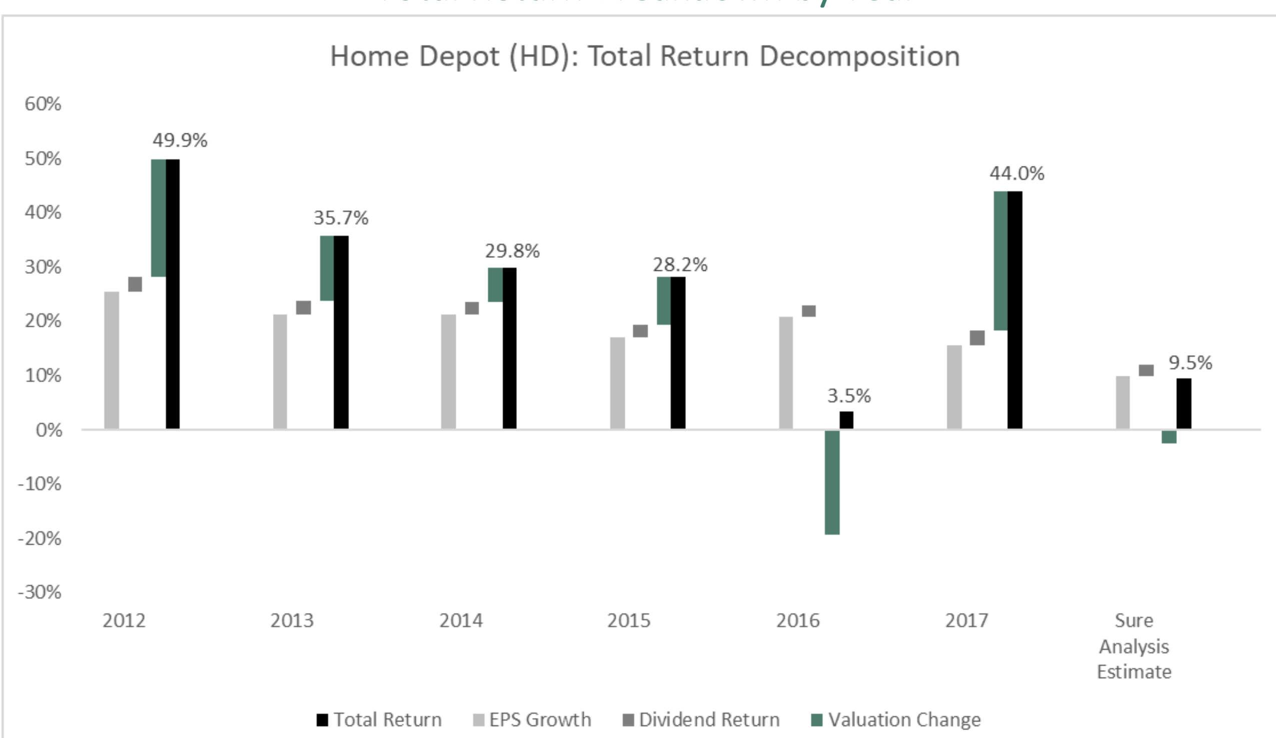
Home Depot's quality metrics have been a mixed bag in the past decade as margins have steadily but slowly moved lower, debt has increased, interest coverage has moved higher and the payout ratio has drifted downward. Gross margins remain around 32% and we do not expect that will change as it continues to offer its enormous assortment of products at competitive prices. Home Depot's SKU assortment is so vast that margin movement one way or the other is difficult but given its operating leverage from higher comp sales, this is more than acceptable. Debt has increased of late to fund share repurchases but given that HD is at 90% of assets funded by debt, we expect this will slow somewhat. Interest coverage and payout ratios are both safe and will not be issues anytime soon.

Home Depot's competitive advantage is in its enormous footprint, strong brand recognition and huge assortment. Supplanting its dominant position in home improvement will be extremely difficult for all comers, including rival Lowe's. It will suffer during a recession, but any weakness would be a buying opportunity, as it was during the Great Recession.

Final Thoughts & Recommendation

Home Depot looks slightly overpriced, but it certainly has appeal is in its earnings and dividend growth outlooks. We expect total annual returns of 9.5% going forward, consisting of the current 2.1% yield, a 2.6% headwind from the valuation heading back to more normalized levels and 10% earnings-per-share growth. Home Depot's fundamentals and growth catalysts are intact; the stock is certainly a long-term hold at current prices. Home Depot will be a strong buy when it trades at or below fair value.

Total Return Breakdown by Year



Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.