Home Depot (HD)

Updated November 19th, 2018 by Josh Arnold

Key Metrics

Current Price:	$177	**5 Year CAGR Estimate:**	12.2%	**Volatility Percentile:**	29.8%
Fair Value Price:	$176	**5 Year Growth Estimate:**	10.0%	**Momentum Percentile:**	60.4%
% Fair Value:	100%	**5 Year Valuation Multiple Estimate:**	-0.1%	**Growth Percentile:**	88.7%
Dividend Yield:	2.3%	**5 Year Price Target**	$284	**Valuation Percentile:**	51.8%
Dividend Risk Score:	C	**Retirement Suitability Score:**	C	**Total Return Percentile:**	72.6%

Overview & Current Events

Home Depot was founded in 1978 and since that time has grown into a juggernaut home improvement 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 $202 billion, making it one of the larger companies by market capitalization in the US.

Home Depot reported Q3 earnings on 11/13/18 and results were characteristically strong. However, some relatively cautious commentary from management sent shares lower, continuing a weak performance for 2018. Total sales were up 5% as comparable sales rose 4.8% globally, but 5.4% in the US. Transactions rose 1.4% while higher average ticket made up the balance of the increase. Gross margins expanded fractionally, adding 20bps in Q3, while those gains were offset by a 30bps increase in SG&A costs. That kept operating margins flat at 14.7%, which is congruent with the first half of the year. Merchandise inventories rose significantly, adding 9.9% during Q3. In total, earnings-per-share rose 36% to $2.51 as the company continues to grow by adding revenue and reducing its share count.

Management implied a slightly below-forecast Q4 with updated guidance of $9.75 for the full-year; the same number we've updated our estimate to after the report. Management said Q4 comparable sales growth will slow from the first three quarters of the year given that it saw significant hurricane-related sales in last year's Q4, which are unlikely to be replicated this year. Total share repurchases are slated to be around $8 billion and the company's store count should remain essentially flat. Operationally, Q3 was largely in-line with expectations as Home Depot fires on all cylinders.

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	***$9.75***	***$15.70***
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***
Shares	1,696	1,698	1,623	1,537	1,484	1,380	1,307	1,252	1,203	1,158	***1,110***	***1,000***

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. We see five-year annual earnings growth of 10%, consisting of 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, although 2018 has been slightly off forecast. Home Depot's growth catalysts are still intact, and we see a continuation of its very strong performance.

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	***18.2***	***18.1***
Avg. Yld.	3.5%	3.5%	3.0%	2.8%	2.1%	2.1%	2.2%	2.0%	2.1%	2.2%	***2.3%***	***2.2%***

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The stock has come well off of its highs in recent months and is much cheaper than it was at the time of our last report. Indeed, shares trade for 18.2 times our earnings estimate for this year, which is almost exactly where we see fair value. Thus, essentially no impact on total returns is now forecast after our previous reports showed Home Depot as overvalued. The yield should remain about where it is in the years to come given that earnings and the dividend should expand at roughly congruent rates. This is the most advantageous time to buy Home Depot in the past several years.

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%***
Liab./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%	***42%***	***38%***
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%***

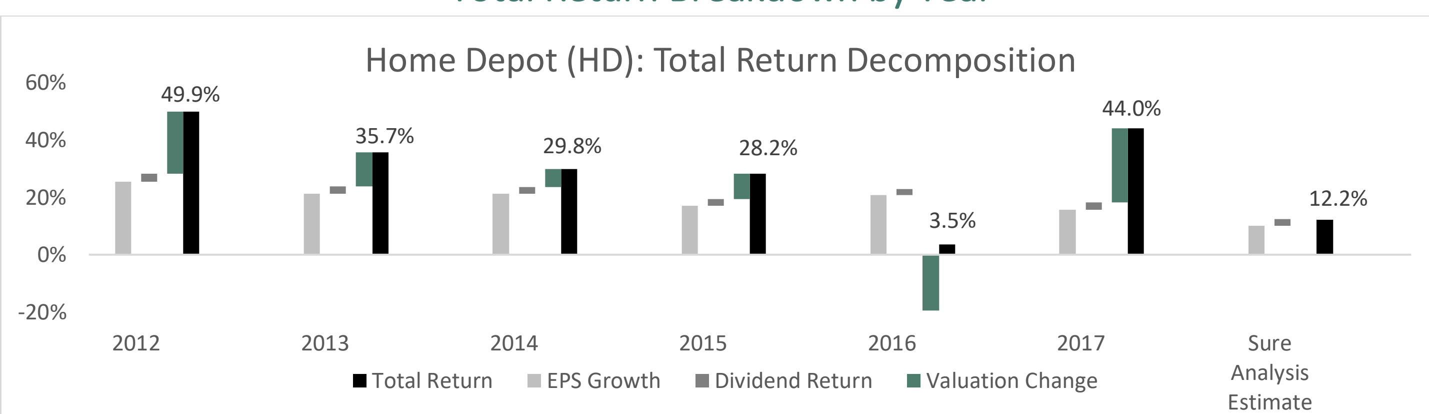
Home Depot's quality metrics have been a mixed bag in the past decade as gross margins have steadily but slowly moved lower, debt has increased, interest coverage has moved higher and the payout ratio has drifted downward. Gross margins remain around 32% and we do not expect that will change as it continues 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 liabilities, 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 inventory variety. Supplanting its dominant position in home improvement will be extremely difficult for all comers, including rival Lowe's. The company is likely to suffer during a recession, but weakness would be a buying opportunity for long-term investors.

Final Thoughts & Recommendation

Home Depot looks fairly valued for the first time in a long time. In addition, it still has appeal is in its earnings and dividend growth outlooks. We expect total annual returns of 12.2% going forward, consisting of the current 2.3% yield, a 0.1% headwind from the valuation and 10% earnings-per-share growth. Home Depot's fundamentals and growth catalysts are intact, and we now rate the shares a buy given that they are finally trading for fair value. Home Depot offers investors the chance to own a stock that is dominant in its industry with terrific earnings and dividend growth outlooks for a reasonable price.

Total Return Breakdown by Year



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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.

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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue ($B)	71.29	66.18	68.00	70.40	74.75	78.81	83.18	88.52	94.60	100.90
Gross Profit	23990	22412	23304	24262	25842	26915	28389	30265	32313	34356
Gross Margin	33.7%	33.9%	34.3%	34.5%	34.6%	34.2%	34.1%	34.2%	34.2%	34.0%
SG&A Exp.	17846	15902	15849	16028	16508	16122	16280	16801	17132	17864
D&A Exp.	1902	1806	1718	1682	1684	1757	1786	1863	1973	2062
Operating Profit	4359	4803	5839	6661	7766	9166	10469	11774	13427	14681
Op. Margin	6.1%	7.3%	8.6%	9.5%	10.4%	11.6%	12.6%	13.3%	14.2%	14.5%
Net Profit	2260	2661	3338	3883	4535	5385	6345	7009	7957	8630
Net Margin	3.2%	4.0%	4.9%	5.5%	6.1%	6.8%	7.6%	7.9%	8.4%	8.6%
Free Cash Flow	3681	4159	3489	5430	5663	6239	6800	7870	8162	10134
Income Tax	1278	1362	1935	2185	2686	3082	3631	4012	4534	5068

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	41164	40877	40125	40518	41084	40518	39946	41973	42966	44529
Cash & Equivalents	519	1421	545	1987	2494	1929	1723	2216	2538	3595
Acc. Receivable	N/A	N/A	N/A	1245	1395	1398	1484	1890	1570	1604
Inventories	10673	10188	10625	10325	10710	11057	11079	11809	12549	12748
Goodwill & Int.	1134	1171	1187	1120	1170	1289	1353	2102	2093	2275
Total Liabilities	23387	21484	21236	22620	23307	27996	30624	35657	38633	43075
Accounts Payable	4822	4863	4717	4856	5376	5797	5807	6565	7000	7244
Long-Term Debt	11434	9682	9749	10788	10796	14724	17197	21216	23601	27028
Total Equity	17777	19393	18889	17898	17777	12522	9322	6316	4333	1454
D/E Ratio	0.64	0.50	0.52	0.60	0.61	1.18	1.84	3.36	5.45	18.59

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	5.3%	6.5%	8.2%	9.6%	11.1%	13.2%	15.8%	17.1%	18.7%	19.7%
Return on Equity	12.7%	14.3%	17.4%	21.1%	25.4%	35.5%	58.1%	89.6%	149%	298%
ROIC	7.5%	9.1%	11.6%	13.5%	15.8%	19.3%	23.6%	25.9%	28.7%	30.6%
Shares Out.	1,696	1,698	1,623	1,537	1,484	1,380	1,307	1,252	1,203	1,158
Revenue/Share	42.28	39.11	41.01	44.84	49.47	54.96	61.79	68.99	76.66	85.22
FCF/Share	2.18	2.46	2.10	3.46	3.75	4.35	5.05	6.13	6.61	8.56

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.