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**FEATURE**

# The Gut Renovation at Home Depot

By NEIL A. MARTIN

***Home Depot's chief executive, Frank Blake, is working to repair the damage done by ousted leader Robert Nardelli -- while also coping with consumers' retrenchment. But the restoration of America's largest home-improvement chain is coming along nicely. (Video)***

**A FEW WEEKS AFTER HE BECAME THE** chief executive of [Home Depot](#) in January 2007, Frank Blake visited one of the company's stores in Scottsdale, Ariz. In front of the "orange box," as company insiders refer to the retail outlets, Blake found a pyramid of stacked lawn tractors. Selling lawn mowers in the desert didn't seem like a profit opportunity to him. "So I asked the store manager how many tractors he sold in a year," Blake recalls. "He told me he sold only one tractor the previous year."



Courtesy of Home Depot

Blake looks more comfortable in an orange apron than in a business suit.

It wasn't Home Depot's (ticker: HD) only odd merchandising ploy. There were snowblowers on display at Florida outlets, beach chairs on offer in landlocked Kansas, and dozens of organic fertilizers available in stores that needed just a few.

"I figured there might be something I didn't understand about this business," Blake laughs.

An executive vice president in business development before replacing ousted chief Robert Nardelli, Blake is trying to solve these and other problems at Home Depot. The turnaround seems headed in the right direction, even if it is proceeding a little unevenly, mostly due to consumers' recent reluctance to open their wallets, particularly for big-ticket items like, well, lawn tractors.

The new chief executive is trying to refocus and energize store staffs whose morale sagged under Nardelli. He is closing businesses like loss-making Home Expo design stores and selling HD Supply, a more successful wholesale-distribution business aimed at professional contractors. Both units were deemed to draw too much executive attention from Home Depot's core mission of selling home-improvement items to consumers.

Blake hasn't been as successful with the share price, which has dropped 40%, to 25 since he assumed the top job. Although it has also gotten hit by the economy, Home Depot's closest rival, [Lowe's](#) (LOW), which has championed personal service, has seen its stock fall by a narrower 37%. Some investors believe underperformance will change during the next year or two, as Home Depot snaps back with the economy. An added plus: the shares' 3.9% dividend yield.

"We believe that Home Depot is going to be the stock to own going into its current fiscal year, and we would be buyers at current levels," writes analyst Deborah Weinswig with Citigroup Global Markets. She has raised her price target to \$32 with a Buy rating. The stock trades at a price-earnings multiple of 17 times, compared with Lowe's 16 times.

"Home Depot has greatly improved under Blake," says analyst Colin McGranahan with Bernstein Research in New York. "He has focused on operations and the more efficient allocation of capital, and both are showing good results, which are helping the company in its restructuring efforts," he says.

Under Blake, who looks more comfortable in an orange apron than a business suit, Home Depot is returning to its roots, supplying home repair and improvement products such as plumbing, electrical and kitchen items, hammers, light bulbs and paintbrushes along with advice.

Blake has put the brakes on expansion. The company has some 2,200 stores, and expects to add only 12 this year, a dramatic change from the 150-a-year pace of a few years ago.

Blake is also working to improve the customer's buying experience, another sore point during Nardelli's tenure. Blake has stressed added worker training and hired more trade specialists to explain products and provide advice. A bold move in a weak economy, Blake spent a combined \$2.4 billion during 2007 and 2008 to make the huge stores more comfortable and customer-friendly, and he plans to spend nearly \$1 billion more this year.

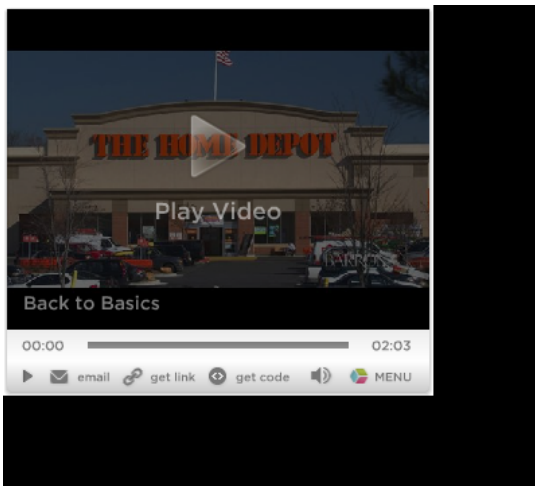
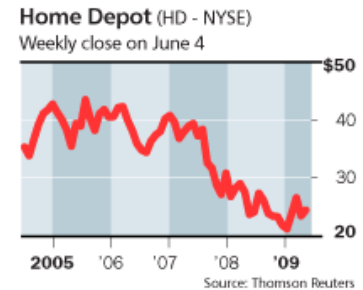
"The economic downturn gave us the time and circumstances to make needed changes," Blake told *Barron's*. "People understand the need for change when things are bad and risks are lower. We needed to get back to basics."

Home Depot also has revamped its supply chain by rolling out six new rapid-deployment distribution centers serving their stores (with plans to add another 14 by 2010). These centers are more modern, cost-efficient, and more highly automated than the previous traditional warehouse-distribution complexes.

Blake's successes and challenges were both evident in the company's May 19 earnings call, when it reported better-than-expected earnings -- even as revenue fell in fiscal 2009's first quarter, which ended May 3.

The company posted a profit of \$514 million, or 30 cents a share, up 44% from \$356 million, or 21 cents, a year earlier. Yet revenue dropped by 9.7%, to \$16.2 billion, as same-store sales fell 10%. The fiscal 2009 results, however, were skewed, because they included higher costs related to the closing of Home Depot's Expo home-design centers. Still, both earnings and revenue figures topped analysts' expectations.

Management also reaffirmed its estimate for fiscal 2009 of a 9% sales decline with negative comparable-store sales in the high-single-digit area and earnings per share from continuing operations off 7%. "We saw improvements in small-ticket -- less than \$50 -- transactions and smaller outdoor projects and maintenance and repair items," says Barclays Capital analyst Mike Lasser. "Consumers are spending on home-improvement products," he notes, "but big-ticket items remain weak. Eventually, that will get better. And this is a key for the bull case for the stock."



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The consensus forecast for fiscal 2009 is \$1.40 per share in earnings, which may grow to \$1.55 in 2010, as gross margins continue to widen under Blake.

More important, the company, which claims 20% of the \$350 billion global home-improvement market, reported 21 of its top national markets were showing a lower rate of decline, particularly in the worst-hit states of California and Florida, where Home Depot has a large number of stores. They are still falling, but not as precipitously. And, as in the previous quarter, Home Depot gained market share.

**AND THERE ARE SIGNS CUSTOMER** service is improving. *Barron's* recently visited the company's showcase Manhattan store to solicit advice about how to retila a kitchen floor.

#### The Bottom Line

At 25, Home Depot's battered stock price looks like a bargain as a leveraged play on an economic rebound beginning over the next 12 months or so. Upside should take it to the 30's.

It was 1 p.m. on a Saturday, and not only were we quickly and warmly greeted, but a lot of employees were out on the floor. Sign of a weak economy? No, a new policy mandates that all floor associates drop whatever they are doing between 10 a.m. and 2 p.m. to wait on customers.

We were escorted to the floor-tile department, where Clayton, a salesperson, showed us samples, provided estimates for installation and introduced us to a Do-It-Yourself booklet. We were quoted a price that was more than double what we would pay if we did the job ourselves.

"Why so much more expensive?" I asked.

"Because we are Home Depot," Clayton replied. "We are professionals and have to guarantee the quality of our work. You get what you pay for."

Blake's gung-ho message seems to be getting through.

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