July 11, 2021

Baird Equity Research

Retail / Consumer Products & Services

The Home Depot, Inc. (HD)

Takeaways from Baird's Virtual Meeting with HD

We hosted a virtual investor meeting last week with HD's CFO Richard McPhail and members of the IR team. We have summarized our high-level takeaways below, and our detailed notes from our discussion can be found herein.

- **DEMAND**
  - HD is operating in "demand satisfaction" mode, not demand "creation" mode
  - HD believes the home improvement sector is moving from a Covid-led story to a housing-led story, and that the demand backdrop is durable (particularly the next 3-5 years)
- **INVESTMENT**
  - HD is now looking years ahead when thinking about investment – focused on staying ahead of the customer and not being in a catch up situation ever again
  - HD has an agile mindset now – allocating resources on a monthly basis (vs. annual planning historically)
  - "Arms race" surrounding data science is underway – gains accrue to the scale players (like HD) - true personalization is the next frontier on HD's investment cycle
- **COST CONTROL**
  - HD intends to extend their position as low-cost provider in home improvement – increasing the "intensity" around this internally
  - Richard feels a need to re-establish HD's credibility around cost and show investors their ability to deliver on the productivity/cost management front
- **INFLATION**
  - Seeing broad-based inflation, not just sector specific - this makes it easier for all retailers to pass through pricing as consumer expectations include some level of inflation
  - HD's approach to pricing has not changed – have finger on pulse of elasticity - will always aim to drive top line momentum – trying to be careful with pricing actions to not slow sales momentum

Valuation Synopsis

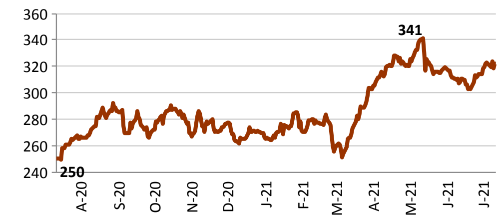
Our $360 price target assumes ~24x FY22E EPS, above the stock's three-year average of ~20x given strong execution and an upward bias to estimates.

Risk Synopsis

Risks include housing market deterioration, reduced credit availability, irrational pricing, and FX-related exposure to international operations.

FLASH REPORT

1-Year Price Chart



Stock Data

Rating:	Outperform
Suitability:	Average Risk
Price Target:	$360
Price (7/11/21):	$322.09
Market Cap (mil):	$346,247
Shares Out (mil):	1,075.0
Average Daily Vol (mil):	3.95
Dividend Yield:	2.05%

Estimates

FY Jan	2020A	2021E	2022E
Q1	2.08 A	3.86 A	
Q2	4.02 A	4.42 E	
Q3	3.18 A	3.24 E	
Q4	2.74 A	2.73 E	
Fiscal EPS	**12.03 A**	**14.25 E**	**14.85 E**
Fiscal P/E	26.8x	22.6x	21.7x

Chart/Table Sources: FactSet and Baird Data. Price chart reflects most recent closing price.

EPS (Net): FY20 EPS excludes a one-time charge of $0.09 related to the acquisition of HD Supply.

Please refer to Appendix - Important Disclosures and Analyst Certification

Home Depot is the world's largest home improvement retailer, operating stores across the U.S., Canada, and Mexico, that cater to do-it-yourself and professional customers.

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HOME IMPROVEMENT DEMAND / MACRO COMMENTS:

- HD has been in what feels like a "storm environment" for over a year
- Management has been "trying to find evidence of pull forward in demand, but that has been elusive" – for example, management has been looking for a pull forward of demand in appliances for a decade but growth persists...
- HD is operating in "demand satisfaction" mode, not demand "creation" mode
- Pro backlogs are at all-time highs
  - Have not seen any major/notable category shifts as the economy re-opened, but have observed an increase in larger project demand as consumers let Pros back into their homes
  - Some ebbs/flows – there are only so many rooms you can paint/so many projects you can pull off as a DIY-er
- The housing market is extremely supportive of repair/remodel activity – much different environment than 2005/2006 – HD believes the demand backdrop is durable (particularly the next 3-5 years)
  - Just because a homeowner invested in their home last year, does that mean they will stop investing this year? HD believes home improvement projects have ascended the rank-order of homeowner priorities
  - Credit conditions are stable, credit/income/wealth profiles of homeowners are healthy
  - Personal balance sheets are in great shape, and consumers are now oriented toward investing more in their homes
  - Relationship between home price appreciation leading to higher home improvement demand should continue to hold
    - Home price appreciation cannot continue at the current rate indefinitely, but even if home prices stabilize in 2022 the sector should still benefit from two years of DD% home price gains and a much higher percentage of wealth tied up in the housing stock
  - Turnover and home price appreciation tend to have lag effect on demand – should underpin demand for a while
    - If mobility/turnover decreases due to tight supply or affordability challenges, this might hurt some sectors of housing but could be good for HD >> more remodel-related spend if you don't/can't move
- HD believes the home improvement sector is moving from a Covid-led story to a housing-led story
  - Installed base of homes has not changed materially, but homeowners are now better off given price appreciation – seeing higher levels of engagement within core categories like lawn/garden

INVESTMENT PROGRAM / PHILOSOPHY:

- Just finished a unique investment phase at HD – "never want to go through it again," referring to the element of "catch up" spending that had to occur
- Feel great about the investments that have been made – looking back, needed to shore up some infrastructure and customer facing areas – believe investments have translated to market share gains
- Made big investments in the in-store environment:
  - Made stores easier to shop ("wayfinding" package), easier to get in/out – "environmental" upgrades and lighting upgrades
  - Improved the interconnected experience – developed a best-in-class app that customers can use to look up inventory availability, locate product in the aisle
  - Front end enhancements have shortened checkout times
- Digital investments were made to handle sustained elevated traffic levels - precisely what they saw for much of last year
  - Realized step changes in online conversion over past 3 years
- HD is now looking years ahead when thinking about investment – focused on staying ahead of the customer and not being in a catch up situation ever again
  - Investment cadence going forward should be smoother, not as lumpy as 2018-2020; expect capex to roughly run at ~2% of sales
  - Opportunities exist to further improve customer experience and solve friction points with "ordered" product (digital, special order, installation); if downstream supply chain takes off, could lean in here
  - Have agile mindset now – allocating resources on a monthly basis (vs. annual planning historically) – not afraid to pivot, look to fail fast, but cheaply – HD was not that kind of company in 2017, but feels like they are now
  - Management wants HD to be more of a disruptor/growth business
- One Supply Chain – took longer to get off the ground (had to acquire land, stand up facilities) – have seen some great results from the more mature platforms within the network
  - Conventional direct fulfillment centers – added one DFC recently
  - Adding capacity through MDOs (market delivery operations)

    - Primarily used for appliance delivery (~50% of appliance volume are currently flowing through MDO's), but will include other big/bulky products over time
    - Appliance fulfillment used to be managed by third party (GE) – they held inventory and handled delivery
    - MDOs are now enabling a top-notch appliance delivery experience
    - Targeting ~100 MDOs by end of 2022
  - HD is pioneering two new fulfillment platforms => MDCs (market delivery centers) and FDCs (flatbed delivery centers)
  - MDCs are designed to handle last-mile delivery of big/bulky, higher volume items (like grills and vanities) - take burden off the stores
    - Same-day/next-day delivery will offer a unique value proposition
    - Targeting ~20 MDC's by end of 2022
  - FDCs are designed to eliminate inefficiencies, capacity constraints associated with store-based delivery on flatbed trucks – FDCs have multiple levels of value creation
    - Will be able to stock a broader assortment in stores with deeper inventory - show the Pro customer that HD offers thousands of SKUs for delivery (rather than dozens)
    - Next layer of value creation – how far can they push this? What other type of customer can they capture with these capabilities?
    - Richard believes their supply chain investments (primarily FDCs) could not come at a better time
    - Targeting ~30 FDC's by end of 2022

REDEFINING THE CUSTOMER EXPERIENCE:

- See a tremendous opportunity to redefine the customer experience around order processing/delivery and eliminating friction
  - Will require notable tech spend - more of a process change around investment focus as opposed to any material change in the level of overall investment
- Making a big push into personalization – been talking about it for years, still feel like they are in the early innings – HD wants to be the best in tailoring to customer needs – see spend/conversion both increasing significantly over time
- Customer file is growing – authentications are up significantly
  - HD knows customers much better today than 18 months ago – customers are responding well to personalization
  - As environment becomes more stable/consistent, HD plans to come back and talk more about customer file
- Arms race surrounding data science is underway – gains accrue to the scale players – true personalization is the next frontier on HD's investment cycle
  - Power lies with data – question is who can attract/afford a critical mass of data scientists to drive personalization (HD is doing so)

LOW-COST STRATEGY / FINANCIAL FLEXIBILITY:

- Intend to extend their position as low-cost provider in home improvement – increasing the "intensity" around this internally – part of the flywheel (lower costs allows HD to provide better value to customers, which drives market share gains)
  - HD didn't have a true low-cost discipline during the housing/financial crisis – did not have a structured way to manage costs and hold people accountable
  - "Culture of cost" was built during 2010-2012 - created a product cost economics group exiting the crisis – developed an objective view of what product costs should look like and how to advise merchants on what those should look like – also ramped up investments in analytics and procurement (aka "operations cost transparency")
  - FY18-FY20 operating performance included "noise" additional capex/opex (associated with accelerated investment plan) plus COVID costs (largely behind the company)
  - Richard feels a need to re-establish HD's credibility around cost and show investors productivity gains/demonstrate their ability to deliver on cost control
- HD is relatively advantaged vs. smaller peers given their discipline around being the low-cost provider
  - High variable cost model offers financial flexibility – payroll is the biggest expense and moves with sales
  - It is still early on the supply chain front, but the downstream supply chain transformation should decrease opex as a % of sales
- Richard stressed the company's financial flexibility/agility
  - The business is prepared to manage costs in two environments: a stabilizing economy or a general downturn – HD would "plow ahead" with investment plans in a stabilization scenario, but a general recession might lead to a different approach – would pull more levers than just payroll (investments)

COST INFLATION / PRICING ACTIONS:

- Seeing broad-based inflation, not just sector specific - this makes it easier for all retailers to pass through pricing as consumer expectations include some level of inflation
- Cost pressures are real – HD understands cost as well as anyone can – starts with mitigation efforts with suppliers
  - Conversations with suppliers are always more frequent in this type of environment – requires more work to reach "market-clearing" price levels – not unfamiliar with this situation
  - HD understand costs deeply and how to mitigate the pressure
  - Product cost team digs deep into supply chain economics, manufacturing capacity, FX/tariffs, etc. in order to ensure that HD is generating appropriate profitability while mitigating costs
  - Commodity categories move up and down in real time – big price swings (like in lumber) have some elasticity impact but HD has no real issue/concerns around their ability to manage through this inflationary period
- Approach to pricing has not changed – have finger on pulse of elasticity
  - Will always aim to drive top line momentum – trying to be careful with pricing actions to not slow sales momentum
  - Approach is not different, just very active in today's environment

GLOBAL SUPPLY CHAIN DISRUPTIONS:

- Import categories tend to see more pressure – lead times, FX, port challenges
- HD is 70% domestically-sourced from a point of manufacturer standpoint, so in good relative shape vs. certain other sub-sectors of retail
- Doing everything they can to get their hands on product – on a relative basis, scale helps HD
- Not going to predict when global supply chain pressures abate (somewhat a function of demand), but HD is in the business of procuring product – top priority is to maintain in-stocks

HD SUPPLY INTEGRATION:

- HD Supply is exciting for what it means in the residential MRO space – combining the two scale players is a huge competitive advantage
- When HD begins optimizing the selling approach across the platforms, rationalizing product assortment, optimizing vendors, and optimizing supply chain, there will be nothing like else it in the space
- Opportunity for HD to grow its current ~10% share of the ~$50B+ residential MRO space
- Efficiencies through HDS are a step change from how HD previously served MRO – HDS provides better building blocks to grow market share

Appendix - Important Disclosures and Analyst Certification

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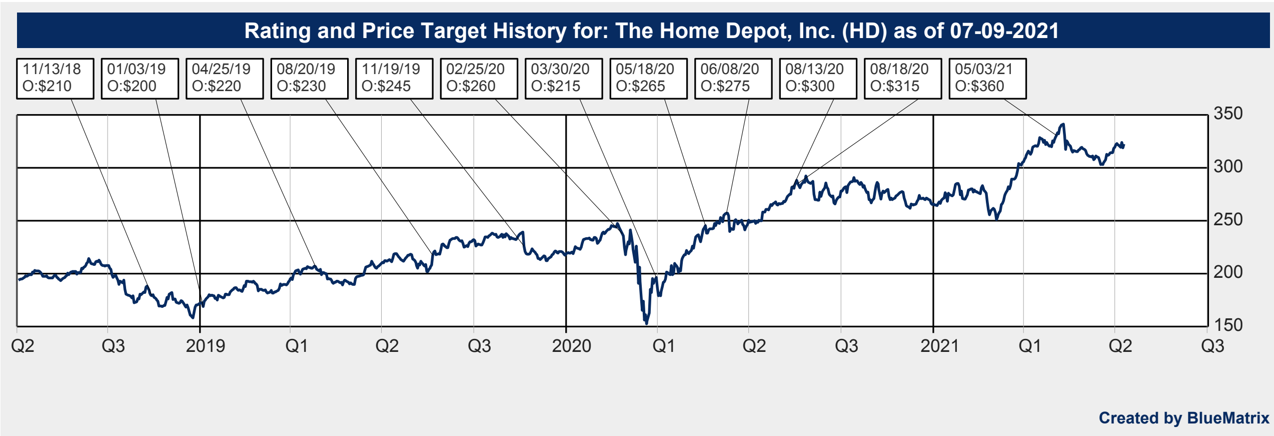

1 Robert W. Baird & Co. Incorporated makes a market in the securities of HD.

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