STRATEGIC REPORT FOR
LOWE’S COMPANIES, INC.

GOTHAML O B A L.

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Executive Summary

Lowe’s Companies is world’s the second largest home improvement retailer, operating 1,234 stores in 49 states, representing approximately 140 million square feet of retailing space. Just twenty years ago, Lowe’s operated some 300 stores, which were, at 20,000 square feet, one-fifth the size of its rival, Home Depot. Beginning in 1989, Lowe’s pursued an aggressive growth strategy, replacing its smaller stores with larger warehouse stores. Lowe’s also expanded into new markets, through both internal growth and acquisition. Today, the Company’s products and services include home decorating, maintenance, repair, remodeling, and the maintenance of commercial buildings. The company primarily retails to do-it-yourself (DIY) customers, however, it is expanding its presence in do-it-for-me (DIFM) and commercial business markets.

From 2003 to 2006 sales at Lowe’s grew at an 18% compound annual growth rate (CAGR), outpacing the sub-industry rate by more than 4%.

This growth was driven by the opening of new stores and, more importantly, increases in same-store sales. During this same period, Home Depot focused on cutting costs, and in doing so it greatly diminished in-store service, which eventually adversely affected sales growth and stock performance. The success of Lowe’s has been driven by its superior reputation for customer service and more appealing store designs. The outlook for long-run sales growth is, however, suspect due to a softening housing market and a closing service gap with Home Depot.

This report focuses on two main strategic issues. First, given Lowe’s current expansion into the Home Depot’s strongholds in California, Florida, and the Northwest, Gotham Global holds that Lowe’s must retain its competitive advantages in customer service and store layout. This issue is extremely relevant considering that the recent reports by the American Customer Satisfaction Index indicating that Home Depot is closing the service gap. If Lowe’s loses this competitive advantage its margins will suffer.
Second, Gotham Global recommends that Lowe’s expand upon its current plans for international growth. The decline in the U.S. housing market poses a serious risk to Lowe’s. International expansion is a natural hedge against this risk exposure. Specifically, Lowe’s should work to expand its operations into China, and quickly. Traditionally, Lowe’s has succeeded as a second-mover. In the last decade it has essentially followed the strategy of Home Depot. The Company’s second-mover strategy, however, has only been successful because of its vast experience in the U.S. market. That is, Lowe’s has discovered a mix of products, services, and store design that are superior to Home Depot’s, and consequently, it has been able to compete with Home Depot as a second-mover. This strategy, however, is not viable in the Chinese market, and given the expansion of home improvement retail in China and Home Depot’s recent acquisition of the Chinese retailer, The Home Way, Lowe’s is ceding Home Depot and other Chinese home improvement retailers a first-mover advantage.

COMPANY BACKGROUND

Mr. L.S. Lowe founded Lowe’s Companies in 1921 in North Wilkesboro, North Carolina as a family run company. By 1945, Mr. Lowe’s son Jim and son-in-law H. Carl Buchan were running the stores. Buchan bought out Jim Lowe in 1956, but retained the family name so as to keep the catchy slogan, “Lowe’s Low Prices.” Buchan quickly set out to expand the company’s territory, opening new stores in North Carolina, Tennessee, Virginia, and West Virginia.

In addition to aggressive expansion, Buchan set out to establish a profit-sharing plan for Lowe’s employees. Sadly, Buchan did not live to see his plan fulfilled; suffering from a fatal heart attack at the young age of 44 in 1960. In the year after Buchan’s death, Lowe’s management and the executors of Buchan’s estate bought up his 89% stake in the company and created the Lowe’s Employees Profit Sharing and Trust, which was eventually renamed Lowe’s Companies. Management used a public offering to finance this repurchase, and by 1979 public shares of Lowe’s were listed on the NYSE.
In the 1970s, Lowe’s derived the majority of its revenue from sales to professional homebuilders. Consequently, as housing starts dropped in 1980, profits fell. Lowe’s thus sought to expand its customer base beyond professional homebuilders. Lowe’s accordingly began to expand its operations to appeal to do-it-yourself (DIY) consumers. To do this, Lowe’s redesigned half of its 229 stores. In its redesigned stores, Lowe’s employed softer lighting and large displays of entire rooms. Lowe’s store designs were especially aimed at attracting women customers, who make up a majority of the DIY customer base. This new strategy proved successful, and by 1982 sales to non-commercial customers accounted for a majority of Lowe’s revenue.

As Lowe’s shifted its strategy towards DIY customers, a new competitive monster was born. Based in Atlanta, Georgia, Home Depot revolutionized the home improvement industry. Home Depot was the first to employ “Big-Box” retailing in the hardware industry. That is, by offering highly personalized service within a warehouse the size of multiple football fields, Home Depot was able to out-compete other smaller home centers and established a new industry standard. By 1989, Home Depot passed Lowe’s as the top home retail chain because of the massive size of its warehouses and aggressive expansion.

To compete with Home Depot, Lowe’s shifted its strategy in 1989 to focus on building larger stores and expanding existing stores. In fact, the Lowe’s corporation cites 1994 as the founding of the modern Lowe’s. Lowe’s expanded aggressively, opening 29, 37, and 42 stores in 1995, 1996, and 1997 respectively. In 1998 the Company announced that it would spend an estimated $1.5 billion to open 100-stores in the Western U.S. To aid its westward expansion, Lowe’s purchased the Seattle-based Eagle Hardware & Garden in 1999 with a stock swap worth $1.3 billion.

Despite Lowe’s adoption of “big-box” retailing, in-store strategy remained constant. Lowe’s continues to uphold its corporate mantra, “improving home improvement,” and consequently its newer and larger stores have retained the
soft lighting and pleasant designs first introduced in 1980. The Company has also been able to maintain its highly personalized service throughout its expansion. Home Depot, on the other hand, has struggled to maintain high levels of service as it expands. This service gap partially explains the performance gap between the two companies.

In 2006, the Lowe’s Company opened 155 stores, and it plans to open 150 to 160 in 2007. Lowe’s believes that there is potential for 2,000 stores in North America. Today, Lowe’s has scaled back its 140,000 square-foot store, and instead operates an 117,000 square-foot prototype in large markets and a 94,000 square-foot prototype in smaller markets.ii
COMPETITIVE ANALYSIS

INTERNAL RIVALRY

Lowe’s Companies competes in the Home Improvement and Hardware Retail industry. It competes with a number of traditional hardware, plumbing, electrical and home supply retailers, in addition to other chains of warehouse home improvement stores and lumberyards. Finally, for some products, Lowe’s also competes with discount stores, mail order firms, warehouse clubs and online retailers. Home Depot is Lowe’s most direct competitor. Together, Home Depot and Lowe’s control approximately one-third of the U.S. home improvement market. There are, however, numerous smaller retailers such as True Value and Ace Hardware that continue to struggle to adapt their models’ to effectively compete with the “Big-Box” methods employed by Lowe’s and Home Depot. Lowe’s sells over 40,000 products for do-it-yourself consumers and professionals. Its products and services range from appliances, home fashion items, lumber, millwork, plumbing to electrical supplies, tools, and furniture. The principle competitive factors in the industry include price, location of stores, customer service, product mix, and name recognition.

The home improvement market is intensely competitive. Lowe’s and Home Depot’s aggressive expansions in the U.S. indicate that this intense competition will persist in the long run. Additionally, as Lowe’s enters more major metropolitan markets, direct competition between the two retailers will surely intensify. The intense internal rivalry within the industry is largely a function of the nature of the products being retailed. That is, since the products offered by home improvement retailers are often identical or very close substitutes, cross-price elasticities are substantial. Low product differentiation combined with low, and decreasing, switching costs—switching costs decrease as the number of home improvement centers increase—indicate that firms stand to gain significant market share by undercutting one another’s prices. Given this incentive structure, there is substantial downward pressure on prices. Lowe’s accordingly
guarantees that its prices are the lowest and if a customer finds a lower price for a
given product Lowe’s will beat it by 10%. To combat the low switching costs and
product differentiation within the industry Lowe’s uses marketing and
advertising campaigns in order to create brand recognition. The Lowe’s brand is
largely based on customer service, evidenced by its simple slogan, “Improving
home improvement.” To maintain its brand, Lowe’s is constantly renovating its
current stores and adjusting its product mixes. In addition, Lowe’s heavily
invests in the back-end of its business.

Distribution is of critical importance to the viability of home improvement
retailers. A cost-effective and efficient distribution network drives costs down
while allowing firms to effectively adjust to changes in demand. Since its
inception in 2004, Lowe’s has been instituting its Rapid Response
Replenishment (R3) initiative. Through significant investments in its distribution
framework, Lowe’s has supported new store expansion, while improving
operating efficiency. In 2004, approximately 50 percent of Lowe’s products
moved through the distribution network, compared with 70 percent in 2006.iv
The Company continues to expand its distribution network, with two regional
flatbed distribution centers to be built in 2007, bringing the total to sixteen.

Due to the intense internal rivalry and the significant cost advantages enjoyed by
Lowe’s and Home Depot, smaller firms are losing money and market share.
Lowe’s and Home Depot, conversely, are both profitable and expanding their
market shares through aggressive expansions. Lowe’s, which traditionally
focuses on medium-sized markets, is now expanding into large metropolitan
areas—those with populations in excess of 500,000. The Company, however,
remains loyal to its traditional customer base, with approximately half of its
planned openings in rural markets. Despite the extensive growth of the big-box
retailers, smaller firms can remain competitive if they can offer better services
than their larger counterparts.
The threat of entry in the home improvement retail industry is minimal. Lowe’s and Home Depot benefit from economies of scale in distribution and purchasing. National distribution networks have reduced the national firms’ inventory costs. Since a new entrant could not manage its inventory as efficiently as the current firms, all else equal, it would not remain profitable given the intense internal rivalry within the industry. Second, national firms benefit from bargaining power with key suppliers. The ability of Lowe’s and Home Depot to negotiate favorable contracts with key brand-name suppliers cedes them a cost advantage over firms with less bargaining power. It is important to point out, however, that national retailers such as Wal-Mart and Sears are not significantly affected by these two barriers to entry due to the size and efficiency of their existing distribution networks and the potential magnitude of their bargaining power. Companies like Wal-Mart and Sears would, however, still face substantial fixed costs considering the massive scale that market entry would require. Moreover, to combat encroachment by potential entrants, Lowe’s and Home Depot have pursued aggressive marketing campaigns stressing low prices and excellent service, creating an intangible barrier to entry. Potential entrants must therefore overcome the brand-recognition that Lowe’s and the Home Depot have established through decades of marketing. Together, these barriers to entry indicate that there are significant fixed costs associated with entering the industry and that the threat of entry is very low.

It is also important to recognize the looming threat of post-entry competition. The aggressive tactics employed by Home Depot employed in the 1990s to eliminate competition. This history combined with the current levels of internal rivalry within the industry suggests that an entrant would be forced to survive in a brutally competitive environment. In short, the threat of entry is very low given the intense internal rivalry between the two main firms. The main threat of entry is from an existing national retailer such as Wal-Mart, but full market entry by such a retailer is very unlikely considering the high fixed costs, the potential for
vicious post-entry competition such as aggressive price-cutting by incumbents, and the brand recognition that has been established by Lowe’s and Home Depot.

**Substitutes and Complements**

There are many potential substitutes to Lowe’s products. Each Lowe’s center offers approximately 40,000 products, in addition to hundreds of thousands of special order products and a variety of professional installation services. Substitutes include completed home decoration products and the high-end installed home-improvement services offered by local specialty firms. The products offered by stores such as IKEA offer a cheap alternative to do-it-yourself projects. On the other end of the spectrum, there are premium products like those offered by high-end retailers such as Restoration Hardware. Professional home-improvement services and products are direct substitutes to the do-it-yourself products offered by home improvement stores. However, this is not necessarily problematic because professionals, like their weekend-warrior-do-it-yourself counterparts, must purchase their supplies from somewhere, and many companies within the industry supply to both groups.

The housing market and home-ownership rate complement industry demand. As homes increase in value, so do the values of home improvement projects. This indicates that the home improvement retail industry benefits from a strong housing market. Additionally, home improvement retailers stand to gain from housing market since builders and new homeowners buy appliances for new homes. Finally, as home-ownership rates increase, individuals have more incentives to invest in their homes, increasing industry demand. Home ownership rates and the housing market are thus important metrics for measuring the potential sales growth within the industry.

**Supplier Power**

The large size of Lowe’s helps minimize the effect of supplier power on its profits. In their annual report, both Lowe’s and Home Depot stress the critical importance of retaining key relationships with brand-name suppliers. The
product mix is extremely important to sales, and consequently certain brand names are able to extract rents. The major risk is that if Lowe’s does not offer certain brand name products that are available at Home Depot it will lose customers and market share. The bargaining power of the major brand name suppliers is, however, limited due to the magnitude of the potential losses that a supplier would face if it lost a contract with Lowe’s or Home Depot. The limits on supplier power are further demonstrated by fact that Lowe’s purchases some 40,000 products from approximately 7,000 suppliers around the world. In fact, due to the sheer size of Home Depot and Lowe’s, suppliers are willing to give better services at lower prices. This lack of supplier power is equivalent to the aforementioned assertion that bargaining power restricts entry.

**BUYER POWER**

The majority of Lowe’s sales are to DIY consumers. As individuals, each buyer is essentially powerless in affecting Lowe’s prices. Collectively, however, buyers have implicit power that arises from their willingness and ability to shop at different stores. This implicit buyer power combined with the ease with which prices are observed and adjusted indicates that more general supply and demand forces, not explicit buyer power, determine prices. This is reflected in the consistent margins earned by Lowe’s and Home Depot over the last few years. Commercial consumers and special order consumers retain more buyer power, but given the magnitude of these individual sales relative to total sales, it is not material.
**SWOT Analysis**

**Strengths**

Lowe’s main strengths lie in its customer service and store layout. Lowe’s ranked second in customer satisfaction among specialty retailers according to the 2005 American Customer Satisfaction Index. The same index ranked Home Depot dead last. The importance of customer satisfaction to company performance is evident in the two companies’ stock performance. In 2001, Lowe’s and Home Depot had the exact same score for customer satisfaction. History, however, reveals that 2001 was a point of divergence for customer satisfaction, with Lowe’s moving up and the Home Depot moving down. Interestingly, stock performance roughly paralleled this trend, with Lowe’s consistently outperforming Home Depot, supporting the argument that the market places a premium on customer service.

Lowe’s strength in customer service comes from the top down. The Company initiated a customer-focused program in 1999 that track performance so as to reward employees. Stores in each region are scored quarterly and the stores that receive a gold, silver, or bronze rating receive cash prices. In addition to the positive incentive effects, the data from this program has helped Lowe’s recognize the causes of service failures. This commitment to customer service has paid off, and is one of the main drivers behind Lowe’s immense success in the past decade.

In addition to its reputation for excellent personalized service, Lowe’s is reputed for its product mix and store layouts. Lowe’s stores are preferred to those of Home Depot, especially to the female demographic through its large displays and bright lighting. To maintain these strengths, Lowe’s invests heavily in signage, displays and other in-store upgrades. In 2005, the Company invested $650 million in upgrading its current stores, and then another $800 million in 2006. Strong operating cash flows have allowed Lowe’s to maintain its existing stores and invest heavily in new stores. Between 2002-2006, operating cash flows
increased at a CAGR of 24%. This strong cash flow growth has also allowed Lowe’s to retire long-term debt, pay regular dividends, and repurchase shares.\textsuperscript{vii}

**Weaknesses**

Lowe’s is extremely vulnerable to market conditions in the U.S. Lowe’s plans to open six to ten stores in the greater Toronto area this year, and then another five stores in Monterrey, Mexico by 2009. Home Depot, conversely, operates 61 stores in Mexico and another 155 in Canada, where it is the market leader.\textsuperscript{viii} The extent of Home Depot’s international operations indicates that it is less exposed to adverse fluctuations in U.S. market conditions. This further indicates that Lowe’s is in a weaker competitive position than Home Depot with respect to dealing with a softening housing market or falling consumer confidence. Additionally, Lowe’s is missing out on potential economies of scale in purchasing.

Lowe’s warehouses are absent from many of the most lucrative U.S. markets. Only 55% of its stores are located in the top 100 U.S. markets, which represent more than 65% of the total market. The Company is thus missing out on high-value regions in the market. Its lacking presence in these lucrative markets helps to explain Home Depot’s superior sales per square foot. Lowe’s isremedying this weakness, however, by focusing its 2007 expansion on the top 100 U.S. markets.\textsuperscript{ix}

**Opportunities**

There is substantial opportunity for international growth. With a population in excess of one billion, a rising middle class, one of the highest rates of home ownership in the world, and ever strengthening property-laws, China is an obvious target for international expansion. Lowe’s is also in a position to greatly expand its installed sales product base because of the aging population. According to the U.S. Census Bureau, one in five U.S. citizens will be over the age of 65 by 2030. This “65 and above” demographic represents an enormous potential market for the DIFM products available at Lowe’s, which have enormous potential for increasing margins in the future. Analysts further argue
that as baby boomers spend more time at home with their families, they will allocate more of their disposable income to home improvement projects. Finally, there is still substantial opportunity for Lowe’s to improve upon its distribution network. Lowe’s has already realized strong returns from its investment in the Rapid Response Replenishment initiative over the past few years. As Lowe’s continues to expand, continued optimization of the distribution network will reduce inventory costs and enhance the Company’s ability to rapidly accommodate any fluctuations in demand.

**Threats**

Shifts in the housing market represent a substantial threat to the financial performance of Lowe’s. During 2006, existing home sales dropped by more than 8 percent, representing the worst decline in 17 years. In the fourth quarter—during which the housing market was hit the hardest—Lowe’s experienced an 11.5 percent drop in year-by-year profits. During this same period the Company’s revenue fell by 3.7 percent, and same-store sales—a key metric for determining performance—declined by 5.3 percent. Home Depot, however, suffered worse with a 5.1 percent decrease in revenue and a 6.6 percent decrease in same-store sales.xi

Intense competition further threatens the long-term performance at Lowe’s. The industry is already very competitive, and the expansionary plans of Lowe’s and Home Depot are very ambitious. Despite the declining housing market, Lowe’s is planning to open 160 stores in 2007. There is no sign of let-up either; Home Depot plans to open 300 to 400 new stores by 2010, and Lowe’s has set a store target of 2,000, approximately 600 more than it already operates. As the U.S. market becomes more saturated there is little doubt that the bottom line will suffer. Both Lowe’s and Home Depot must thus be wary of overexpansion in the U.S. Additionally, as Lowe’s opens new stores, it is critical that it negotiate

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1 Housing slump hits Lowe’s: Profits down for big names in home improvement, The Charlotte Observer (North Carolina), February 24, 2007 Saturday, BUSINESS AND FINANCIAL NEWS
favorable contracts with local governments. The success of the Company’s growth strategy hinges on its ability to find favorable locations and negotiate favorable renting terms.

Finally, Lowe’s current growth strategy is threatened by its shrinking service gap with Home Depot. Lowe’s quest for market share is dependent on its ability to retain this competitive advantage over Home Depot. If this gap continues to close, Lowe’s will no doubt miss out on market share, which in turn will drive margins down. Without an advantage in customer service, Home Depot will be better able to utilize its current competitive advantages in store location and distribution efficiency to capture market share from Lowe’s.
FINANCIAL ISSUES

Lowe’s is a very healthy company financially. The current ratio of 1.27 indicates that the Company is not in any current financial distress. Moreover, its leverage and debt to equity ratios are consistent with Home Depot and the industry median.

<table>
<thead>
<tr>
<th></th>
<th>LOW</th>
<th>HD</th>
<th>Industry Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Ratio</td>
<td>1.27</td>
<td>1.39</td>
<td>1.79</td>
</tr>
<tr>
<td>Quick Ratio</td>
<td>0.20</td>
<td>0.40</td>
<td>1.10</td>
</tr>
<tr>
<td>Leverage Ratio</td>
<td>0.16</td>
<td>0.22</td>
<td>0.18</td>
</tr>
<tr>
<td>Total Debt/Equity</td>
<td>0.28</td>
<td>0.47</td>
<td>0.44</td>
</tr>
<tr>
<td>Interest Coverage</td>
<td>33.46</td>
<td>24.74</td>
<td>13.42</td>
</tr>
</tbody>
</table>

Lowe’s has outperformed the S&P 500 during the past five-years. Lowe’s performance has been driven by its consistent sales growth and cost reductions. Between 2003 and 2006, sales at Lowe’s grew at an 18% compound annual growth rate (CAGR), outpacing the sub-industry rate by more than 4%.\textsuperscript{xii2} The stock performance of Lowe’s relative to the S&P can be seen in the graph below.
More importantly, however, Lowe’s has consistently outperformed its closest rival Home Depot, due in part to the fact that Home Depot overlooked consumer needs throughout the past five-years while under former CEO, Bob Nardelli. Nardelli put too much stress on the bottom line. Consequently, despite a healthy balance sheet, steady sales growth, and strong profit margins, Home Depot’s stock suffered. Lowe’s stock performance relative to Home Depot’s over the last five years is presented below:

It is important to notice that Lowe’s has maintained this performance gap despite the fact that Home Depot has consistently earned a higher return on equity (ROE) over this same period. This trend can be seen in the graph below.
This graph very clearly demonstrates the importance of service in the home improvement industry. That is, despite Home Depot’s higher ROE during the past five years, Lowe’s trades at a premium relative to Home Depot.

<table>
<thead>
<tr>
<th>Multiple</th>
<th>LOW</th>
<th>HD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price/Sales</td>
<td>1.01</td>
<td>0.82</td>
</tr>
<tr>
<td>Price/Earnings</td>
<td>15.69</td>
<td>13.56</td>
</tr>
<tr>
<td>Price/Book</td>
<td>3.03</td>
<td>2.99</td>
</tr>
<tr>
<td>Price/Cash Flow</td>
<td>10.6</td>
<td>9.76</td>
</tr>
<tr>
<td>EV/EBITDA</td>
<td>1.98</td>
<td>0.95</td>
</tr>
</tbody>
</table>

Lowe’s premium over Home Depot can be explained by a plethora of factors. Most important, however, are the points that the market is clearly putting a premium on the customer service at Lowe’s, and that Lowe’s is perceived to have stronger growth opportunities than Home Depot. There is a causal relation between these two factors. That is, the perception for future growth is dependent on Lowe’s ability to continue to take customers away from Home Depot, which in turn hinges on its ability to retain its advantages in customer service and store design. It is thus crucial that Lowe’s retain these competitive advantages.
Using DuPont analysis, it is possible to better determine why Lowe’s ROE is lower than that of Home Depot.

<table>
<thead>
<tr>
<th>DuPont Analysis</th>
<th>LOW</th>
<th>HD</th>
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</thead>
<tbody>
<tr>
<td>Profit Margin</td>
<td>6.62%</td>
<td>6.34%</td>
</tr>
<tr>
<td>Asset Turnover</td>
<td>1.79</td>
<td>1.88</td>
</tr>
<tr>
<td>Financial Leverage</td>
<td>1.75</td>
<td>1.86</td>
</tr>
<tr>
<td>ROE</td>
<td>20.69%</td>
<td>22.18%</td>
</tr>
</tbody>
</table>

From this table, it is clear that Lowe’s profit margin is above that of Home Depot, but that its asset turnover and financial leverage are slightly lower. First, with respect to financial leverage, Lowe’s growth strategy is currently more aggressive than Home Depot’s. This implies that Lowe’s faces more risk of financial distress. However, given Lowe’s consistent cash inflows over the past decade and its large stockpile of cash, taking on more debt to enhance shareholder return is a viable strategy. The Company’s current share repurchase is in accordance with this recommendation, and Lowe’s ROE will increase as leverage rises. Second, Lowe’s asset turnover ratio is lower than that of Home Depot, indicating that Home Depot generates more sales per dollar of asset. As Lowe’s enters into the more lucrative metropolitan markets, this difference should decrease. Based on its current expansion into metropolitan markets and share repurchase program, Lowe’s ROE will increase relative to Home Depot’s. In fact, if Lowe’s can retain its current profit margin advantage it seems that Lowe’s will soon achieve a higher ROE than Home Depot.

From an operating standpoint, Lowe’s operations have been improving in efficiency. Over the last three years return on assets (“ROA”) have increased from 6.22% in 1999 to 11.85% 2007. During this period, Home Depot’s ROA has
remained relatively constant, while Lowe’s continues to steadily increase. This relation is depicted in the graph below.

![Return on Assets Graph](image)

This increase in ROA indicates that Lowe’s is using its assets in a more efficient manner, and as previously mentioned, one can expect this figure to rise as Lowe’s continues to grow and expand its presence in the more lucrative U.S. markets.

<table>
<thead>
<tr>
<th>Operations</th>
<th>LOW</th>
<th>HD</th>
<th>IND</th>
</tr>
</thead>
<tbody>
<tr>
<td>Days of Sales Outstanding</td>
<td>1.25</td>
<td>12.95</td>
<td>29.07</td>
</tr>
<tr>
<td>Inventory Turnover</td>
<td>4.5</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Asset Turnover</td>
<td>1.8</td>
<td>1.9</td>
<td>1.9</td>
</tr>
</tbody>
</table>

The table above indicates that Lowe’s is much better than Home Depot and the industry at collecting accounts receivable. The 11.75 reported difference between the two Companies’ reported figures literally means that Lowe’s converts its receivables into cash 11.75 days faster than Home Depot. This is an advantage for Lowe’s in that it can use the cash from its sales much more quickly than Home Depot. Conversely, Lowe’s may be able to boost its sales by offering more
favorable credit terms to its customers. This figure is expected to rise in the near future as the Company’s credit financing—introduced in 2006—becomes more popular. Further marginal analysis as to the effects of different credit policies is necessary.

The inventory turnover ratio is the most important metric of operational efficiency. It measures how many times a company’s inventory is sold and replaced during an accounting period. Lowe’s inventory turnover ratio of 4.5 therefore implies that, on average, it sells its entire inventory in 81.1 days \((365/4.5)\). Home Depot on the other hand goes through its inventory in only 73 days. This seemingly small difference is very important given the immense magnitude of the two companies’ inventories. Home Depot’s higher inventory ratio implies that it has less money tied up in inventory than Lowe’s. This is beneficial for two reasons: 1) Home Depot can invest more cash in interest earning assets; and 2) it can reduce borrowing, reducing interest expense. As Lowe’s continues to grow and realize economies of scale in distribution, inventory turnover should increase. To maximize the gains from improvements in distribution, the Company must also continue to improve upon its inventory management systems. This is a critical issue to Lowe’s due to the intense price competition within the industry. Lowe’s must thus continue to invest in its R3 initiative and improve its distribution and inventory management techniques to boost inventory turnover and reduce inventory costs. There are no problems with Lowe’s current strategy in this area. Gotham Global holds that as the Company’s rapid expansion winds down, and equilibrium is achieved, that more efficiencies in inventory management will be realized.
STRATEGIC ISSUES AND RECOMMENDATIONS

The two major strategic issues Lowe’s must consider concern its in-store services and international expansion.

MAINTAINING SERVICE SUPERIORITY

Currently, 55% of its stores are located in the top 100 U.S. markets, which account for more than 65% of home improvement market. This absence from many of the most lucrative U.S. market explains Home Depot’s $100 advantage in total sales per square foot. Consequently, Lowe’s is currently expanding into major metropolitan markets. As Lowe’s enters these markets direct competition with Home Depot will rise dramatically, and, consequently, it is critical that the Company retains its current competitive advantages in service and store-layout.

The importance of customer service within the home improvement industry is evidenced in Home Depot’s poor performance under former CEO Bob Nardelli. In his effort to cut costs and boost profitability, Nardelli increased the proportion of part-time employees who had little knowledge about home improvement. This policy eventually diminished Home Depot’s once venerated customer service reputation. As Home Depot’s service reputation plunged, customers began to switch to Lowe’s, which led to drops in Home Depot’s same-store sales and stock price. During this time, Lowe’s has established a very strong service reputation, which has helped to fuel its same-store growth between 2001 and 2005. This critical service advantage, however, may not be sustainable in the long-term, as Home Depot is already frantically investing in in-store improvements and customer service initiatives to close the service gap with Lowe’s. Note that the recent problems facing Home Depot suggest that boosting margins at the cost of customer service is not a viable long-term strategy.

The competitive implications associated with Home Depot’s service improvements are more severe due to Lowe’s current struggles to uphold its previous levels customer service. In the four years prior to 2006, the companies’
ASCI scores moved in opposite directions, with the Home Depot score falling and the Lowe’s score rising. Interestingly the companies’ stock performance mimicked this trend in service reputation. Recently, however, this trend has been reversed. In 2006, Lowe’s ACSI score dropped 5.1% to 74, its lowest score ever. Home Depot’s score, on the other hand, increased 4.5% to 70.\textsuperscript{xiv} There are thus two strategic issues facing Lowe’s. That is, Lowe’s must first maintain the customer service reputation that it established prior to 2006, and then come up with service innovations to combat Home Depot’s improving service.

First and foremost, Lowe’s must work hard to retain a strong base of knowledgeable full-time employees. A do-it-yourself project can be daunting. It requires planning and some basic blue-collar know-how, however, a home improvement retailer with a knowledgeable staff helps to lower these hurdles by answering any questions about the installation process or material requirements for all DIY projects. Furthermore, an ideal staff would offer suggestions for project expansion or various other tips. The value of such a staff is difficult to measure because of the long-term effects of a service reputation. This is to say that an attentive labor force will increase sales in the current period and the future because of a higher likelihood of return visits.

At the core of Lowe’s recent drop in customer service is its recent growth strategy. Since 2000, Lowe’s has opened on average 121 new stores per year at a growing rate.

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In recent years, Lowe’s has shifted its focus to major metropolitan markets. The Company is not nearly as experienced in these larger markets where store traffic and sales volume are much higher. It must therefore invest more heavily in customer service initiatives within these new stores to build, as the company puts it, “a bench of tenured and talented people.”\textsuperscript{xv} This is especially important considering that Lowe’s is now entering Home Depot’s strongest markets. Lowe’s
must thus offer more incentives to attract experienced home improvement retailers. Moreover, the Company must bring in talented managers and sales associates to the new regions to ensure that the customer experiences at Lowe’s meets expectations, and more importantly exceed those at Home Depot. If Lowe’s is not able to affirm its superior reputation in customer service and in-store experience in these new regions from the onset, its market share and sales will suffer in the long run. This is an especially time-sensitive strategic issue because of the improving service at Home Depot, because as the service gap closes, DIY customers will be more inclined to base their consumption decisions on convenience and price. In this situation, competition would be based purely on location and prices; and given Home Depot’s distribution and inventory advantages and its presence in all of the top U.S. markets, it is clear that Lowe’s would be at a disadvantage. If Lowe’s, however, can capture market share early by greatly impressing new customers, it will be able to capture some market share.

**U.S. Housing Risk and International Expansion**

Expansion beyond the U.S. market would help ease the adverse effects caused by downturns in the housing market. Lowe’s is currently working on growth strategies in both Canada and Mexico. Specifically, the Company plans to open six to ten stores in the greater Toronto area by year-end, and another three to five stores in Monterrey, Mexico in 2009. The Company’s current international expansion strategy is too conservative, however, because it ignores the Chinese market.

Stronger private property rights, high home-ownership rates and a burgeoning middle class combined with a population of 1.3 billion and a GDP of $1.5 trillion indicate that the Chinese retail market is craving large home improvement centers. Some estimate that this market exceeds $50 billion with a CAGR of 20 percent. Based on these conditions and estimates The Home Depot recently acquired fourteen stores in northern China for approximately $100 million. Additionally, KingFisher, a British home improvement company, operates fifty
stores on Mainland China. Lowe’s is unnecessarily ceding these two retailers a first-movers advantage.

Traditionally, Lowe’s has been cautious of over-expansion. This strategy has paid off in the U.S. market where the Company has been able to win market share from its competitors by exploiting its advantages in customer service and store-layout. Relying on such a strategy in China, however, is very risky. Before becoming the national power that it is today, Lowe’s gained nearly half a century of experience as a regional retailer in North Carolina, which was no doubt invaluable in the development of its extremely successful service strategy. It is unclear whether Lowe’s competitive advantage in the U.S. market will not apply in China due to extensive cultural differences. Chinese consumers, for example, may not care about store-layout or customer service, but instead base their consumption decision solely on price and product mix. Lowe’s is thus risking the loss of a competitive advantage in an enormous potential market to current and potential competition.

Lowe’s also stands to benefit from reduced risk exposure to the U.S. housing market and economies of scale in purchasing. Based on the risks associated with not expanding and potential risk-reductions and economies of scale Gotham Global proposes that Lowe’s Companies move into the Chinese market by opening a flagship store in Shanghai. Such a plan will provide Lowe’s with invaluable information about Chinese consumers and the Chinese home improvement market, and from this point the Company will be able to make a more informed assessment about the earnings potential of the Chinese market.
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