BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Home Depot (HD) EQ Review Update-10/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	5-

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are lowering our *EQ Review* rating on Home Depot (HD) to 4- (Acceptable) from 5- (Strong.)

- Inventory days (DSI) jumped by 3.7 days over the 10/17 quarter. Management stated that this was a planned build meant to increase availability and some inventory pre-buying. We are not overly alarmed by this as inventory was still in a normal seasonal range. However, this is an item to monitor going forward and prompts us to lower our rating from 5 (Strong) to 4 (Acceptable.)

Inventory DSI Jumped by More than 3 Days

HD's inventory days (DSI) jumped by 3.7 days over the 10/17 quarter as shown in the following table:

	10/28/2018	7/29/2018	4/29/2018	1/28/2018
COGS	$17,151	$20,098	$16,330	$15,790
Inventory	$14,754	$14,044	$14,432	$12,748
COGS YOY growth	4.7%	7.8%	3.8%	7.8%
Inventory YOY growth	9.9%	9.1%	6.0%	1.6%
Inventory DSIs	78.5	63.8	80.6	73.7

	10/29/2017	7/30/2017	4/30/2017	1/29/2017
COGS	$16,378	$18,647	$15,733	$14,654
Inventory	$13,419	$12,868	$13,609	$12,549
COGS YOY growth	8.4%	6.3%	5.1%	6.0%
Inventory YOY growth	1.3%	4.4%	3.0%	6.3%
Inventory DSIs	74.8	63.0	78.9	78.1

Management made the following comments regarding the inventory rise in the conference call:

> Carol Tome:
> *"The growth in our inventory versus last year reflects the investments we're making to accelerate merchandising expense [ph], higher in stock levels than we had one year ago and some pull forward of planned inventory purchases."*
>
> Marc Brown:
> *"We continue to expect to see inventory productivity here at the Home Depot, but customer service begins with in-stock, so we really focus mostly on our in-stock. We have implemented tiered replenishment strategies that really provide focused investments to drive sales and in-stock where it matters the most. And the results we're seeing from that are really very good. We've actually reduced the number of out of stocks per store by 24% in our top selling SKUs and folks bringing that to life with the new in-store processes, we feel great about our shelf availability there. On top of that, we've improved our direct fulfillment center in-stocks and service levels to the customers and setting new records in terms of in-stock there. So pleased with our in-stock levels and the investments we've made there."*

Looking further back than 8 quarters tells us that third-quarter DSIs were approximately 80 in both 2016 and 2015, implying that inventory is not especially out of line with recent historical trends. This fact coupled with management's comments above reduce our concern level. Regardless, any sudden increase in inventories at a retailer deserve attention going forward.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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