



LOW: IMPROVING HOME IMPROVEMENT

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RATING: BUY

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Price (8/21/2003):	\$57.45	Dividend:	\$0.10
S&P Index:	1048	Yield	0.2%
52 Week Range	\$33.37 - 58.94	Book Value/Share	\$11.66
Market Cap(mm)	\$45.46B	Earnings	2002 2003 2004
Shares Out (mm)	804M	1Q	\$0.44A \$0.53A
Enterprise Value:	\$44.18b	2Q	\$0.59A \$0.75A
Avg. Daily Volume:	3,895,500	3Q	\$0.43A \$0.52E
LT Debt/Total Capital:	28.20	4Q	\$0.40A \$0.51E
Net Cash/Share:	\$1.93	Fiscal Year	\$1.85A \$2.30E \$2.65E
EV/Revenue	1.7x 1.4x 1.2x	P/E	28.3x 22.7x 19.7x

- **Best Blend of Growth Characteristics Within DIY Group.** Among the DIY hardline retailers, LOW maintains the best growth trends. Comp performance has been strong and consistent; the consensus forecast is for 6% comp growth for 3Q:03, ahead of the 3.5% comp growth seen in the first half of the year. We anticipate operating margin expansion over the next 3 years and footage growth at the high end of the industry (13%-15% annually) without sales cannibalization. LOW continues to invest in its infrastructure to enhance profitability, namely more robust systems for both special order and installed sales tracking.
- **Upside Exists to Consensus 3Q:03 Estimate.** LOW's management recently raised guidance for 3Q:03 EPS to \$0.52-\$0.53 (\$0.52 estimate) based on comps that have consistently exceeded an expected range of 5%-6%. In addition, LOW continues to increase in profitability due to superior merchandising and industry-leading distribution systems; we anticipate revenue per store to increase to approximately \$8.0mm for 3Q:03 (vs. \$7.8mm a year ago). Coupled with the positive pricing trend provided by elevated lumber prices, we are confident in the \$0.52 consensus estimate and certainly think elements are in place for potential upside.
- **High Lumber Prices Could Provide Catalyst.** Average wood product prices for 3Q:03 are trending higher on a sequential quarterly basis. Oriented strand board is currently priced 122% above 2Q:03 prices, and composite lumber a more modest 5%. Higher lumber prices could add roughly 2 points to October quarter comps for LOW and provide upside to our top- and bottom-line estimates.

- **We rate LOW shares OUTPERFORM.** Shares of LOW currently trade at an 11x multiple on an EV/EBITDA basis, and 23x on a P/E basis. Both ratios represent a discount to the high-end of a historical range despite compelling macro trends and a superior company profile. We think strong top-line growth, margin expansion opportunities, and expanding ROIC should support margin expansion. Although we are clearly in the late innings of the stock's recent rally, near-term upside still exists for investors given the current level of lumber prices. Monthly comps and October quarter results will likely exceed consensus forecasts and could provide momentum.

Lowe's Companies Inc. (NYSE: LOW)

Company Description. Lowe's is the second largest home improvement retailer. Located in North Wilkesboro, NC, Lowe's operates over 800 home improvement merchandise and building supplies warehouse stores. The stores cater primarily to the DIY retail consumer, but the company has recently focused more of its attention on serving the business customers in a bid to win more sales from this lucrative and underserved segment of the home improvement market.

Lowe's Companies, Inc. profile. Lowe's Companies, Inc. is a retailer of a complete line of home improvement products and equipment. Revenue in FY:02 totaled \$26.5 billion providing roughly a 20% market share. LOW serves more than 8 million customers in the DIY and commercial markets each week through over 850 stores operating in 44 states. Lowe's is the second largest home improvement retailer (behind The Home Depot) and 14th largest retailer in the United States. Headquartered in Wilkesboro, N.C. Lowe's has been in operation for nearly 58 years and employs over 122,000 people. Approximately 6% of LOW stock is owned by employees via the Lowe's 401(k) plan. LOW has been a publicly held company since October 10, 1961 and the stock is listed on the New York Stock Exchange.

LOW has demonstrated DIY leadership. Over the last few years, LOW has transformed itself into the leading growth company in the home improvement sector by targeting the middle- to upper-income consumers and by supporting its growth with a leading distribution and systems infrastructure. We expect this trend to continue in 2H:03 into 2004, spurring earnings growth of 15%-20%. In our view Lowe's has emerged as one of the best companies among retailers in the past few years. Success has largely been driven by superior merchandising and a system and distribution model designed to emulate Wal-Mart's. Although the technology associated with the distribution center does not yet approach Wal-Mart, LOW still maintains superior distribution and systems for its sector and is among the best in the market. In 2002 LOW began testing and implementing new procedures in conjunction with new technology that helped simplify the Special Order and Installed Sales process. In 2003 Lowe's has initiated the roll-out of further system enhancements that will enable electronic ordering with e-catalogs and EDI interfaces with special order vendors. Increased efficiency in these processes creates value for LOW consumers and provides a significant competitive advantage to "mom-and-pop" home improvement retailers. Technology also plays a significant role by allowing LOW to streamline in returning product to its vendors. Each of these in-store initiatives helped LOW achieve a record operating margin of 9.6% (up 146-basis points) in 2002 and a 43.8% increase in net earnings (to \$1.5 bn) for the year. We forecast a 64-

basis point increase in LOW's operating margin in FY:03 (to 10.2%) and a 25.5% increase in net earnings (to \$1.9 bn).

New store openings. Lowe's expansion has slowed from the robust growth seen in the late 1990's, yet expansion continues. LOW opens a new store on average every three days.¹ The company's opening plans include two prototypes – a 116,000 square-foot store for large markets and a 94,000 square-foot store used primarily to serve smaller markets. Lowe's two prototype store plan is part of a "smart growth" strategy that enabled the company to gain market share while avoiding the sales cannibalization that plagued rival Home Depot. Both prototypes include a lawn-and-garden center averaging an additional 25,000 square-feet. At the beginning of 2003 square footage totaled approximately 95 million square-feet, after 123 new store openings in 2002 – the majority of which were in metropolitan markets. In 2003, LOW plans to open 130 new stores and continue to emphasize cities with populations greater than 500,000 such as New York, Philadelphia and Los Angeles.² Lowe's plans to invest approximately \$1 billion to open more than 60 stores in the greater New York City area, adding momentum to its aggressive expansion plan. This move is part of a long-term strategy to create a major presence in the Northeastern U.S. where the company currently has a limited presence. Through 1H:03 Lowe's has opened 42 new stores bringing its total to 896 stores. Although total square footage growth has moderated from the 31% level achieved in FY:00, we think Lowe's can continue to grow square footage at roughly the 15%-17% level as the company takes share from "mom-and-pop" outfits. Accordingly we forecast 16% footage growth in FY:03 and 15% in FY:04 and comp store sales growth in excess of 4%.

Increasing profitability. Lowe's has been driving significant gross margin expansion via a move to more upscale merchandise that carries higher margins. Meanwhile, Lowe's industry-leading sales growth has given it additional status with vendors thus increasing bargaining leverage and ability to increase gross margin. LOW is now the nation's second largest and fastest growing appliance retailer. The company has improved its lighting category by adding brands once exclusively found in specialty retail shops, and increased its focus on flooring to deliver better brands and innovative products. Exclusive retailing contracts LOW maintains with certain brands (e.g. American Tradition paint) continue to provide an additional competitive advantage. By broadening its merchandise offering, Lowe's has situated itself to adequately meet shifting consumer shopping patterns. In this respect LOW has roughly a two year head start on chief rival The Home Depot which is now attempting to follow suit with a similar product broadening. However, first-mover advantage among the big-box retailers and a superior operating system give LOW the distinct advantage in this arena for at least the next couple of years. Significant opportunities exist for Lowe's to increase share since of the 18 broad categories of products the company sells, home centers hold a leading share in only 5, and over 40% share in only one. SG&A should remain flat as Lowe's reinvests the gains generated by strong gross margin increases and potential sales upside. We forecast a 5-basis point decrease in SG&A margin in FY:03, increasing to 52-basis points in FY:04.

Impact of lumber market should provide near-term boost. Average wood product prices for 3Q:03 – both dimensional lumber and sheet goods – are trending higher on a

¹ Lowe's Company

² Lowe's 3rd Quarter conference call.

sequential quarterly basis.³ Oriented strandboard is currently priced 122% above 2Q:03 prices, and composite lumber a more modest 5%. Higher lumber prices could add roughly 2 points to October quarter comps for LOW and provide upside to our top- and bottom-line estimates. What accounts for the sharp rise in lumber prices? A combination of weather, war and a record home-building boom offer the likely answers. Drought on the U.S. West Coast, rain and hurricane-type weather on the East Coast, and a forest fire in British Columbia (a major supplier) are the primary reasons the lumber supply is falling short of current demand levels. Meanwhile, historically low interest rates and demographic facilitated housing demand have kept the pace of homebuilding at or near record levels – sales of new homes for August were up 3.4%, the second fastest growth in a month on record. Compounding the issue of supply was the recent purchase of 20 million square feet of plywood by the U.S. Department of Defense for troops in Iraq. Although lumber experts are expecting prices to normalize in 2Q:04, the near-term boost in prices could provide margin expansion for Lowe's as they pass through price increases while maintaining leverage with suppliers.

Income Statement. We anticipate 16%-17% revenue growth in FY:03 and FY:04 for Lowe's, roughly inline with overall square footage growth. Concurrently, we forecast comp store sales of 4%-5% for the company. During this timeframe we expect LOW to expand its gross margin approximately 50-basis points per year on the strength of enhancements to already stellar Special Order and Installed Sales operating systems. We forecast EPS of \$2.30 in FY:03 and \$2.65 in FY:04, representing 24% and 15% per share earnings growth respectively. These estimates compare to the consensus forecast of \$2.29 and \$2.65 in FY:03 and FY:04, respectively. We think elevated lumber prices could provide near-term upside to earnings through the early part of 2004.

Balance sheet and cash flow. While rival big-box retailer The Home Depot carries virtually no debt on its balance sheet, Lowe's maintains slightly more leverage with roughly \$3.7 billion in long-term debt or 31% of book value of assets. The present value of operating lease obligations is currently \$3.3 billion. As of the end of 2Q:F03, LOW had approximately \$1.6 billion in cash on the books and \$2.4 billion in working capital (defined as current assets less current liabilities). ROE of 20.0%, ROA of 10.0% and ROI of 13.3% (all on a TTM basis) are a reflection management's effectiveness and ability to increase shareholder value, in our view. We anticipate capital expenditures of roughly \$2.7 billion annually as Lowe's continues to execute its long-term growth strategy.

Risks. Primary risks to the overall performance of LOW stock in our view include:

- Macro-economic issues such as rising interest rates, consumer confidence, personal income and new home sales
- Cannibalized sales due to over-saturation in Northeast markets
- A price war with The Home Depot
- Profit-taking due to recent strong stock performance

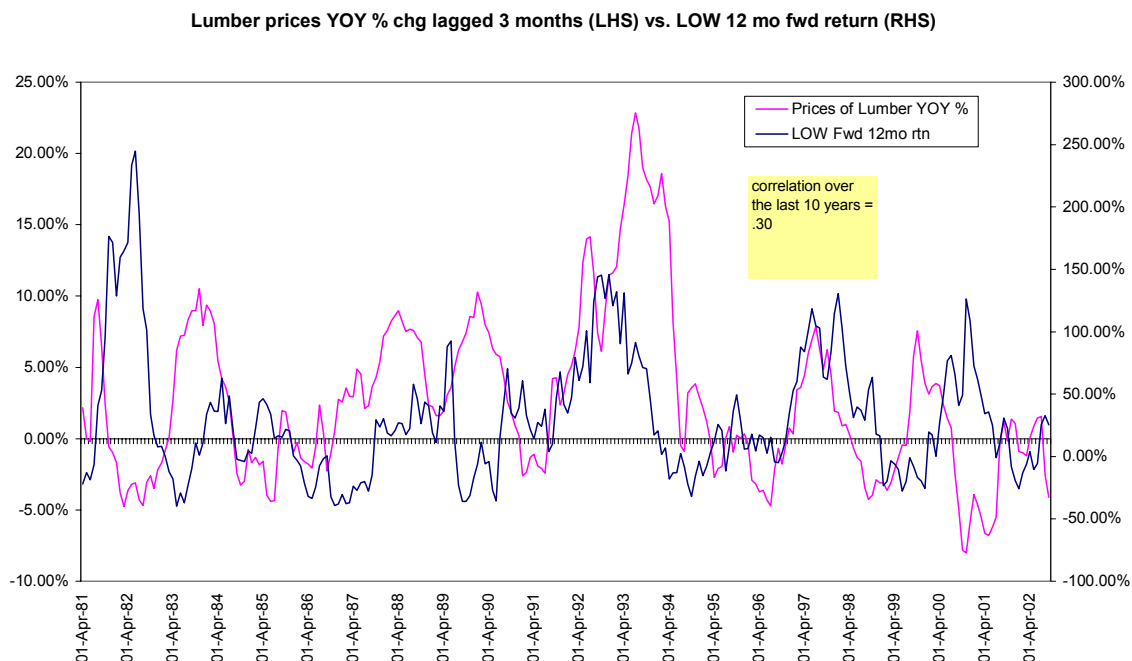
Financial outlook and valuation. We think LOW offers investors long-term growth at a reasonable price. With a leading market position in terms of realized earnings growth Lowe's currently trade at approximately 11x on an EV/EBITDA multiple basis. This represents a discount to peak valuations of 17x achieved during 2001. Trough

³ Legg Mason Estimates

EV/EBITDA multiples for LOW (9x) indicates the downside potential is limited relative to potential upside, creating an attractive risk-reward profile. With key long-term factors for sustained top- and bottom-line growth in place – namely leverage with suppliers, a broadening product offering and streamlining operations – shares of LOW are an attractive long-term buy for investors. Accordingly we rate the stock OUTPERFORM.

Supplement: LOW and Lumber Prices

We undertook an exercise to find correlations between LOW's stock returns and lumber prices, lagged 3 months. In addition, we derived two sets of time-series returns – one of Lowe's 12-month forward return, and another that is risk-adjusted with the CAPM formula. The following graphs illustrate how changes in lumber prices and return variables have behaved over the last 20+ years.



Source: Bloomberg

(The graph with risk adjusted returns and lumber prices looks very similar).

During the entire history of LOW as a public company, the correlation between lumber prices and the return variables is quite negligible (less than 0.10). If the time length is limited to the last 10 years, the correlation is modestly significant at 0.30. We felt that limiting the time history to less than 10 years is not justifiable considering that the company has been public for over 20 years (and in existence for 40).

In short, we see that correlation is modest over the recent time period, but very weak over the entire history of LOW as a public company. This could be due to the possibility that Lowe's actively manages risk to fluctuations in lumber prices with futures contracts. We could not find any disclosure about this in 10-K nor 10-Q of LOW.

EXHIBIT 1 - LOWES EARNINGS MODEL (\$M)

	FY97 Jan-98	FY98 Jan-99	FY99 Jan-00	FY00 Jan-01	FY01 Jan-02	FY02 Jan-03	FY03E Jan-04	FY04E Jan-05	FY05E Jan-06	FY06E Jan-07	FY07E Jan-08
Revenue	\$11,108	\$13,331	\$15,906	\$18,779	\$22,111	\$26,491	\$30,783	\$35,915	\$40,812	\$45,575	\$49,992
Cost of sales	8,152	9,757	11,525	13,488	15,743	18,465	21,261	24,717	28,026	31,229	34,182
Gross profit	2,956	3,574	4,381	5,291	6,368	8,026	9,522	11,198	12,786	14,345	15,810
Selling General & Admin	1,973	2,341	2,772	3,348	3,913	4,730	5,481	6,570	7,256	8,000	8,609
Preopening	73	76	98	132	140	129	140	140	140	120	100
Depreciation	241	289	337	409	517	627	750	878	1,014	1,141	1,252
Operating expenses	2,286	2,706	3,208	3,889		5,485	6,371	7,588	8,410	9,261	9,962
Operating profit	670	868	1,172	1,402	1,798	2,541	3,150	3,610	4,376	5,084	5,848
Interest expense	72	81	85	121	174	182	183	180	180	180	180
Pretax income	598	787	1,087	1,281	1,624	2,359	2,967	3,430	4,196	4,904	5,668
Tax on income	216	287	398	472	601	887	1,121	1,297	1,553	1,815	2,097
Net income	383	500	689	810	1,023	1,471	1,846	2,134	2,644	3,090	3,571
Merger related charges	0	0	15	0	0	0	0	0	0	0	0
Reported net income	383	500	674	810	1,032	1,482	1,853	2,141	2,644	3,090	3,571
Diluted EPS	\$0.52	\$0.67	\$0.88	\$1.05	\$1.30	\$1.85	\$2.30	\$2.65	\$3.23	\$3.70	\$4.19

Diluted shares	739	751	769	769	795	800	805	809	820	836	852
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Footage											
Stores, beginning	402	446	484	576	650	744	854	984	1,124	1,264	1,384
New stores	44	38	92	74	94	110	130	140	140	120	100
Stores, end	446	484	576	650	744	854	984	1,124	1,264	1,384	1,484
Square footage, (mm)	37	43	57	68	81	95	110	127	144	158	170

Margins											
Gross profit	26.61%	26.81%	27.54%	28.17%	28.80%	30.30%	30.93%	31.18%	31.33%	31.48%	31.63%
SG&A expenses	17.76%	17.56%	17.43%	17.83%	17.70%	17.86%	17.81%	18.29%	17.78%	17.55%	17.22%
Preopening expenses	0.65%	0.57%	0.62%	0.70%	0.63%	0.49%	0.45%	0.39%	0.34%	0.26%	0.20%
Operating income	6.03%	6.51%	7.37%	7.47%	8.13%	9.59%	10.23%	10.05%	10.72%	11.16%	11.70%
Net profit	3.45%	3.75%	4.33%	4.31%	4.63%	5.55%	6.00%	5.94%	6.48%	6.78%	7.14%
Tax rate	36.03%	36.45%	36.61%	36.80%	37.00%	37.62%	37.79%	37.80%	37.00%	37.00%	37.00%

Growth Rates											
Comp store sales	5.9%	5.3%	1.2%	2.4%	5.6%	4.6%	4.00%	3.50%	3.50%	3.50%	
Footage	18.9%	31.3%	18.9%	19.0%	17.3%	16.3%	15.1%	13.4%	10.1%	7.6%	
Revenues	20.0%	19.3%	18.1%	17.7%	19.8%	16.2%	16.7%	13.6%	11.7%	9.7%	
Gross profit	20.9%	22.6%	20.8%	20.4%	26.0%	18.6%	17.6%	14.2%	12.2%	10.2%	
Operating expenses	18.7%	18.4%	20.8%	16.9%	20.9%	15.9%	19.9%	10.4%	10.3%	7.6%	
Operating profit	29.6%	35.0%	19.6%	28.2%	41.3%	24.0%	14.6%	21.2%	16.2%	15.0%	
Net profit	30.7%	37.8%	17.5%	26.3%	43.8%	25.5%	15.6%	23.9%	16.9%	15.6%	
EPS	28.6%	31.7%	20.1%	23.4%	42.6%	24.3%	14.9%	21.8%	14.6%	13.4%	

Change (bp)											
Gross margin	20	73	63	62	150	63	25	15	15	15	
Expense ratio	(19)	(13)	40	(13)	16	(5)	49	(51)	(22)	(33)	
Operating margin	48	86	10	66	146	64	(18)	67	43	54	
Net margin	31	58	(2)	32	93	44	(6)	54	30	36	

Source: Company reports and Legg Mason estimates

EXHIBIT 2 - LOWE'S COMPANIES RETURN ANALYSIS, 1999 - 2005E

	FY99	FY00	FY01	FY02	FY03E	FY04E
REPORTED ROIC CALCULATION						
Reported EBIT	1,172	1,402	1,798	2,541	3,150	3,610
- Taxes	398	472	601	887	1,121	1,297
= Net Operating Profit - After Tax (NOPAT)	774	931	1,197	1,653	2,029	2,314
Operating Current Assets	3,141	3,706	4,067	4,441	5,224	5,877
+ Net Property Plant & Equipment	5,272	7,166	8,794	10,512	12,462	14,284
= Total Operating Assets	8,412	10,873	12,861	14,953	17,686	20,161
Operating Current Liabilities	2,234	2,636	2,858	3,498	4,022	4,702
+ Other Long Term Liabilities	204	255	311	493	487	488
= Total Operating Liabilities	2,438	2,891	3,169	3,992	4,508	5,190
Operating Assets	8,412	10,873	12,861	14,953	17,686	20,161
- Operating Liabilities	2,438	2,891	3,169	3,992	4,508	5,190
= Invested Capital	5,975	7,982	9,693	10,962	13,178	14,971
RETURN ON INVESTED CAPITAL (ROIC)	12.96%	11.66%	12.35%	15.08%	15.40%	15.45%
WACC						
Market Capitalization	20,765	18,006	26,988	34,309	46,632	46,632
Operating Leases	2,603	2,721	2,991	3,163	3,334	3,334
+ Total Debt	1,364	1,727	2,698	3,734	3,736	3,736
= Total Capital Outstanding	24,732	22,454	32,677	41,206	53,702	53,702
Marginal Cost Of Debt	7%	7%	7%	7%	7%	7%
X Marginal Tax Rate	37%	37%	37%	37%	37%	37%
A Cost Of Debt/Leases	7%	7%	7%	7%	7%	7%
B Debt & Leases To Capital Ratio	5.52%	7.69%	8.26%	9.06%	6.96%	6.96%
Beta	1.2	1.2	1.2	1.2	1.2	1.2
X Equity Risk Premium	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
+ Risk Free Rate	5.0%	5.9%	5.9%	4.5%	4.0%	4.5%
C Cost of Equity	11.0%	11.9%	11.9%	10.5%	10.0%	10.0%
D Equity To Capital Ratio	84.0%	80.2%	82.6%	83.3%	86.8%	86.8%
= [A x B] + [C x D] = WACC	9.62%	10.08%	10.41%	9.38%	9.17%	9.17%
ROIC	12.96%	11.66%	12.35%	15.08%	15.40%	15.45%
WACC	9.62%	10.08%	10.41%	9.38%	9.17%	9.17%
(ROIC - WACC)	3.34%	1.58%	1.94%	5.71%	6.23%	6.28%

Source: Legg Mason Estimates, Morgan Stanley, Multex, Group Estimates

Exhibit 3 - DCF Valuation

Lowes DCF Model (\$M)

Free Cash Flow Calculation

EBIT
Plus: Depreciation & Amortization

EBITDA
Less: Capex

EBITDA Less Capex
Less: Taxes on EBIT
Less: Increase In Working Capital

Unlevered Free Cash Flow
YoY Growth

Historical				Projected				
FY99 Jan-00	FY00 Jan-01	FY01 Jan-02	FY02 Jan-03	FY03E Jan-04	FY04E Jan-05	FY05E Jan-06	FY06E Jan-07	FY07E Jan-08
1,172	1,402	1,798	2,541	3,150	3,610	4,376	5,084	5,848
337	409	517	627	750	878	1,014	1,141	1,252
1,510	1,811	2,315	3,167	3,900	4,488	5,390	6,225	7,101
(1,472)	(2,332)	(2,199)	(2,362)	(2,700)	(2,700)	(2,600)	(2,500)	(2,500)
37	(521)	116	806	1,200	1,788	2,790	3,725	4,601
(429)	(516)	(665)	(956)	(1,190)	(1,365)	(1,619)	(1,881)	(2,164)
403	(77)	657	86	289	(27)	(48)	(40)	(35)
(795)	(960)	(1,207)	(237)	(279)	451	1,219	1,884	2,472
	21%	26%	-80%	18%	-262%	170%	55%	31%

DCF Enterprise Value Calculation

Enterprise Value = PV (Forecasted Cash Flows) + PV (Growing Annuity #1) + PV (Growing Annuity #2) + PV (Perpetuity)

Enterprise Value = 3,980 + 9,342 + 11,354 + 35,478 = 60,154

Forecasted Cash Flows	PV
FY 03	(255)
FY 04	378
FY 05	937
FY 06	1,326
FY 07	1,594
Total	3,980

Annuity #1	
Years	5
Growth Rate Unlevered FCF Prior Year	31.2%
Selected Growth Rate	15.0%
WACC	9.2%
Unlevered FCF FY 08	2,843
PV of Annuity #1	9,342

Annuity #2	
Years	5
Growth Rate Unlevered FCF Prior Year	15.0%
Selected Growth Rate	7.5%
WACC	9.2%
Unlevered FCF FY 13	6,146
PV of Annuity #2	11,354

Perpetuity	
Growth Rate Unlevered FCF Prior Year	7.5%
Selected Growth Rate	2.0%
WACC	9.2%
Unlevered FCF FY 18	9,486
PV of Perpetuity	35,478
PV Total	60,154

Source: Company Data, Group Estimates, Morgan Stanley Cost of Capital, Multex Beta

Summary DCF Valuation		
DCF Enterprise Value	\$60,154	19.0x EBITDA
Less: Debt	\$3,816	Annualized

Equity Value	\$56,338	
Shares (PreDeal)	804	
DCF Value per Share	\$70.07	30.4x Proj EPS

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