Lowe's Companies, Inc. (LOW)
1Q Recap: Meeting the Execution Challenge - Reiterate Outperform Rating

1Q performance reinforced our positive view on LOW. In short, the company’s ability to pivot and execute was tested by the unexpected surge in demand and operational challenges created by the COVID-19 pandemic, and it certainly delivered. With an experienced leadership team pursuing multiple business optimization opportunities and consumers intensely focused on improving their homes, prospects for continued progress against LOW’s transformation initiatives appear bright. At just 16.5x our FY21E EPS (>20% discount to HD), there seems to be room for multiple expansion as well. Reiterate Outperform rating/$135 price target.

- **1Q recap.** A blow-out performance with stronger comps and gross margin driving a >30% adjusted EPS beat ($1.77 vs. our/Street’s $1.29/$1.32). Details from our early read note can be found [here](#).

- **Additional sales color.** U.S. comps of +12.3% handily exceeded HD’s +7.5%, and the company’s strong GM performance underscored the quality of the performance. Comps accelerated throughout the quarter, running +5.1%+/8.9%+/20.4% across February/March/April, and 2Q is off to a strong start (May comps trending “at or above” April levels). Strength was broad based across consumer segments (DIY slightly > Pro), merchandise categories (14 of 15 positive) and regions (all 15 positive). Of note, the comp gap between rural (~25% of LOW stores) and urban (~10%) locations was +600bps, and LOW noted ~850bps of net COVID-related sales impact during the quarter (including strength in cleaning products, refrigerators/freezers, and DIY projects).

- **Digital execution impressive.** With LOW’s digital platform transition to the Google Cloud still not complete (targeting end of 2Q), 1Q’s 80% increase in ecommerce sales was particularly impressive. Curbside pickup was rolled out in a matter of days, and ~60% of online orders were picked up at the store. Looking forward, completion of the platform transition will usher in several new digital capabilities for the 2H of the year, including an expanded online assortment, improved drop ship vendor onboarding, coordinated fulfillment by product collection, improved online delivery status/scheduling, dynamic landing pages, increased mobile app functionality, and incremental SKU additions to BOPIS/curbside.

- **Margins didn’t disappoint.** LOW’s better-than-expected GM performance (+164bps) reflected a blend of improved rate, mix and mark-downs. Importantly, LOW’s promotional stance was tempered, as evidenced by the 24% y/y decline number of items sold on promotion during 1Q. SG&A leveraged ~40bps as COVID-related expense deleverage was more than offset by leverage on items including payroll (new labor management system) and advertising. All told, adjusted EBIT dollars increased 40% y/y to $2.0B, exceeding our estimate by ~32%.

- **Model update.** Raising FY20E/FY21E EPS to $6.35/$7.10 (from prior $5.85/$6.90) as we flow through 1Q’s upside and assume higher sales but also higher COVID expenses going forward. With respect to 2Q, we now model EPS of $2.23 (vs. $2.15 prior) with US comps of +7% and ~$370M of COVID expense (vs. 1Q’s $340M).

Lowe's Companies, Inc., is the world's second-largest home improvement retailer, with specific emphasis on retail do-it-yourself (DIY) customers, do-it-for-me (DIFM) customers, and professional customers.

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Details

Comp color. Total company comps increased 11.2%, with U.S. comps up an impressive 12.3% (handily outpacing HD's 7.5%). Comps were primarily driven by an increase in ticket (comp ticket +9.6%) as consumers consolidated shopping trips, though comp transactions were still positive at 1.6%. Comps accelerated throughout the quarter (February/March/April 5.1%/8.9%/20.4%), and 2Q is off to a strong start (May trending “at or above” April’s results). Strength was broad-based across regions (all 15 positive) and merchandise categories (14 of 15 positive), and DIY sales slightly outpace Pro (first time in several years). Ecommerce sales grew at a healthy 80% pace in aggregate during 1Q, including +150% in April. Management noted digital growth rates with Pro customers was even stronger.

![Comps Gain Meaningfully in 1Q](source: Company Reports)

Investment Thesis

- **Emerging culture of accountability and focus.** While executing change can be difficult, a simplified approach to running the business and renewed culture of accountability (every initiative has a designated “captain”) is helping bring greater focus to LOW's strategic priorities. When combined with a new incentive program (which aligns everyone in the company around the same metrics/priorities), we believe execution is poised to improve materially in the years ahead.

- **Several process redesign opportunities.** Marvin and his team have made good progress in addressing some long-standing issues at LOW (out-of-stocks, poor reset execution, end-cap merchandising) by focusing on core retail fundamentals. For example, they have introduced engineered standards around basic store processes (like freight flow), redesigned the reset process (less reliance on third-party labor), improved end-cap productivity, invested in job lot quantities, addressed brand gaps, developed a new payroll allocation system, and simplified store communications to bring clarity/focus to key strategic priorities. All told, we believe Marvin and his team have the right game plan in place to drive steady improvement in LOW's execution and operating performance in the years ahead.

- **Pro: transitioning from retail fundamentals to more strategic initiatives.** While much of FY19 was focused on improving basic retail fundamentals (investment in job lot quantities, improved service levels, dedicated POS terminals), LOW completed the nationwide rollout of a Pro loyalty program earlier this year. This program is integrated with LOW's new CRM system, which should allow for
deeper engagement with Pros (targeted marketing, suggestive selling). All told, we continue to see a significant opportunity for LOW to "do better" with Pros.

- **Significant long-term EPS power.** Management has outlined a roadmap to achieving $370 in sales/sqft (vs. FY19's $345) and ~12% EBIT margins (vs. FY19's 9.1%) "over a reasonable planning horizon." Free cash flow is expected to remain robust as capital previously marked for non-core businesses is being reallocated to fund increased investments in supply chain and IT/systems. When combined with ongoing buybacks, we see ~$9 in EPS power within the next four years.

- **Price target rationale.** Our $135 price target assumes shares trade at ~19x FY21E EPS, above the stock's three-year avg NTM P/E of ~17x but in line with the current NTM EPS multiple given the significant opportunity to drive sales productivity/EBIT margins higher over time.

### Risks & Caveats

- **Deceleration in housing.** Deterioration in the housing market could negatively impact demand for LOW's products/services, particularly those driven by housing turnover activity. In addition, continued home price depreciation could cause incremental weakness in home improvement-related spending as homeowners remain reluctant to invest in higher-ticket projects/renovations in the midst of falling home values and equity extraction as a source of funds is largely non-existent.

- **Increased restrictions in credit availability.** Increased restrictions in credit availability could negatively impact sales, as big-ticket projects/home improvements are often financed.

- **Less favorable real estate position in key metro markets.** LOW's real estate disadvantage relative to HD in key metro markets (LOW often the second player in) represents a structural headwind, particularly as consumers focus on convenience.

- **Irrational pricing.** Given the increasingly challenging macro environment, there is heightened risk that industry players could become more aggressive with price in an attempt to drive traffic and market share gains. Any price war would adversely impact both sales and profit margins.

- **Execution risk.** LOW recently restructured its store operations and merchandising organizations in an effort to streamline operations, enhance its value proposition, differentiate its product offering, and improve the customer experience. While we are impressed with the speed/magnitude of change, change carries risk.

- **Economic conditions.** A contraction in consumer spending resulting from macroeconomic factors such as higher interest rates, rising fuel and energy costs, prolonged weakness in the housing market, increased.

### Company Description

Lowe’s Companies, Inc. is the world's second-largest home improvement retailer, with specific emphasis on retail do-it-yourself (DIY) customers, do-it-for-me (DIFM) customers who utilize installation services, and commercial business customers. The company offers a complete line of products and services for home decorating, maintenance, repair, remodeling, and property maintenance to homeowners, renters, and commercial businesses.
Appendix - Important Disclosures and Analyst Certification

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Covered Companies Mentioned
All stock prices below are the 5/19/2020 closing price.

The Home Depot, Inc. (HD - $238.19 - Outperform)
(See recent research reports for more information)

Rating and Price Target History for: Lowe’s Companies, Inc. (LOW) as of 05-20-2020

Rating and Price Target History for: The Home Depot, Inc. (HD) as of 05-20-2020

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

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