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***Important Disclosures Found In Appendix***
**2/19/13**

**Homecenter Industry Update (HD: $67.52 – BUY) (LOW: $39.14 – Neutral)**
**HD+LOW: January and February Sales Look Solid, Some Small Positive Steps Continue at LOW (Cleveland Research)**

**Key Points**

1. We have seen solid comp store sales for the homecenters in January and early February, the solid sales appear across the board within core categories, something that compares to softer sales across most of retail.
2. We see more sales catalysts in place for both HD/LOW in 2013 relative to what was a solid 2012. Strong new construction sales (completions up 25% vs up 10% in 2012) and improving repair & remodel sales and mix should be incremental drivers for 2013. We are seeing both HD and LOW bringing in incremental inventory.
3. Lowe's likely to show incremental margin progress in 4Q (payback from line reviews, slightly slower reset activity). We still see net strategic focus of merchandising efforts pursuing margin at the cost of sales, some tactical changes with inventory and promotions are steps in the right direction.
4. ***Our work suggests solid comp store sales at homecenters over the last 90 days should position HD and LOW for some upside in 4Q: HD comp of 4% (in-line with the mean) and EPS of $0.66 (mean is $0.64), LOW comp at 1.5% (mean is 0.5%) and EPS at $0.25 (mean is $0.23).***
5. ***Within our work we are seeing growing conviction on improvement in 2013 sales from a solid 2012 for both HD and LOW. This suggests both companies can continue posting improved/upside results through the coming quarters.***

**Read Through to the Model**

- HD 4Q EPS modeled $0.66 versus $0.64 consensus driven by gross margin up 20bps year/year (HD guided 4Q gross margin flat)
  - 4Q comp modeled up 4% year/year (note this is 50bps lower than our estimate through December-January compare was toughest of the year). The mean is 3.8%.
- LOW 4Q EPS modeled $0.25 versus $0.23 consensus driven by gross margin up 30bps (LOW guided 4Q gross margin up more than 26bps year/year progress in 3Q).
  - 4Q comp modeled up 1.5% year/year (similar to our estimate through December). The mean is 0.5%.
- We are modeling LOW 2013 comp up 2.5% (the mean is up 2%, 2012E up 1.4%).
  - 2013 EPS modeled in-line with consensus ($2.09) with 20bps gross margin expansion.
- We are modeling HD 2013 comp up 4.5% (mean is 3.8%, 2012E up 4.3%).
  - 2013E EPS modeled $3.55 (mean is $3.48) driven by 20bps gross margin expansion year/year (2012E up 15bps).
- On a 5% industry comp (HD up 5%+, LOW) through 2014, we HD EPS at $4.50 and LOW at $2.75.

**Near-Term Conclusion**

Our work showed solid sales for both HD and LOW in 4Q. February also looks to be off to a good start. The key is we are seeing broad-based strength across core categories including some incremental progress with discretionary/bigger ticket categories and product mix. Our work also shows a larger-than-expected benefit from Sandy rebuild beginning in March, something we expect to add an incremental 50bps to comp store sales in 2013. HD continues to show strong execution. LOW is seeing some incremental sales and margin progress/less disruption via some changes/easing within its line review process. We see comps relatively in-line at HD (4% vs mean at 3.8%) and comp upside at LOW in 4Q (1.5% versus mean at 0.5%). The demand recovery we are seeing underway (improving housing and repair & remodel) can support strong results/likely some upside in 2013.

**Medium/Long-Term Conclusion**

We have seen a broad-based improvement in underlying remodel demand (across categories and across price points) through 2H12 and into early 2013. The better underlying demand and the tailwind of storm-related rebuild in 2013 suggests homecenter comps can improve on the relatively sluggish and choppy 2% annual growth we have seen since 2010 (HD up 3-4%, LOW up 1%, we are modeling 2013E up 4.5% at HD, up 2% at LOW). In a sustained 3% industry comp environment, earnings power looks to be $4.20 at HD in 2014 (HD trading 16x this currently) and $2.50 at LOW (trading 15-16x this currently). In a more meaningful volume recovery, something that is looking more likely (5% industry comps), EPS upside at HD looks to be $4.50 in 2014, with LOW at $2.75 (note this also assumes some closing of the execution/comp gap versus HD).

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| **HD** | **Earnings and Market Data Summary** | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | **CRC** | **Consensus** | | **CRC** | **Consensus** | | | | |
| 1Q12 | $0.65 | | 1Q13E | | $0.75 | Shares Outstanding | 1,495.2 | ROE (Trailing 4Qs) | 24.2% |
| 2Q12 | $1.01 | | 2Q13E | | $1.18 | Market Cap (mm) | $100,954 | Debt/Cap | 38% |
| 3Q12 | $0.74 | | 3Q13E | | $0.86 | 52-Week High | $68.15 | Revenue (Trl 4Qs) | $72,522 |
| 4Q12E | $0.66 | $0.64 | 4Q13E | | $0.69 | 52-Week Low | $45.72 | 5-Year Growth Rate | 15% |
| **2012E** | **$3.06** | **$3.05** | **2013E** | **$3.55** | **$3.48** | Avg Daily Volume | 5,864,105 | | |
| P/E | 22.1 | | | 19.0 | | | | | |

| **LOW** | **Earnings and Market Data Summary** | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | **CRC** | **Consensus** | | **CRC** | **Consensus** | | | | |
| 1Q12 | $0.44 | | 1Q13E | | $0.52 | Shares Outstanding | 1,140.6 | ROE (Trailing 4Qs) | 12.7% |
| 2Q12 | $0.64 | | 2Q13E | | $0.79 | Market Cap (mm) | $44,642 | Debt/Cap | 39% |
| 3Q12 | $0.35 | | 3Q13E | | $0.48 | 52-Week High | $39.98 | Revenue (Trl 4Qs) | $51,104 |
| 4Q12E | $0.25 | $0.23 | 4Q13E | | $0.30 | 52-Week Low | $24.76 | 5-Year Growth Rate | 16% |
| **2012E** | **$1.67** | **$1.72** | **2013E** | **$2.09** | **$2.09** | Avg Daily Volume | 9,022,704 | | |
| P/E | 23.5 | | | 18.7 | | | | | |

**Highlights**

**Homecenter sales solid in January and February.** We have seen solid homecenter sales over the last 30-60 days, continuing the positive momentum we saw in November and December (and for the last 6-9 months in total). The January comparison was the toughest of the quarter (average January-12 comp was up 8.5%, Decemeber-11 was up 5%, and November-11 was up 1%).

Our work suggests sales have been strong in February aided by the snowstorm in the Northeast (cleaned out inventory in the snow category as well; limits markdown risk in the category versus 30 days ago). We have seen core categories also improve in early February.

A key within our work is the improvement we have seen in discretionary/bigger-ticket remodel categories. We have seen sales and mix improvement in cabinets, faucets, and flooring categories to name a few. Impressive is this progress is taking place with less year/year promotional activity.

Our work also shows the strongest comp store sales growth in core categories continues to be on the West Coast, suggesting improving home improvement trends in regions where weather is normal.

Winter seasonal sales have been strong over the last 30 days (benefitting from snow storms, helping February comps improve versus January). Early Spring sales are better than expected in some key markets in the South (Florida and Texas specifically, favorable weather compares helping this), suggesting consumers may be a bit more willing to spend in the seasonal category versus the prior year.

Shipments into the home improvement market look pretty strong as well over the last 30 days as retailers work to keep pace with the improving demand (many instances of shipments outpacing sell-through over the last 30 days; something unusual around fiscal year end).

The solid sales in the home improvement channel compare to softer sales across the majority of retail over the last 30 days (higher taxes, delayed tax refunds), something we will closely watch in the homecenter channel in the coming weeks.

*We are modeling HD comp store sales relatively in-line with expectations (up 4% versus mean up 3.8%) and we see upside at Lowe's (modeling 1.5% versus the mean at 0.5%).*

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**More catalysts in place for the homecenters to generate incremental sales growth in 2013.** We see several positive catalysts in place for the homecenters in 2013, putting this channel in better position than most other retailers.

The incremental positive catalysts include:

- Sandy rebuild impact likely larger than expected, can add 50bps to full year comp (rebuild benefit should hit in March, likely to continue through most of 2013).
- New construction benefit continues to grow as completions growth accelerates (can be up 25% year/year in 2013 versus up 10% in 2012).
- Repair and remodel continues to improve, with 2013 growth likely to be 1-2 points higher than 2012 (up 4-5% versus 2-3% in 2012)
- Home prices are moving higher, helping to drive improving mix trends within key discretionary/big ticket/remodel categories

The high expectations in place for HD and LOW entering 2013 make it difficult to predict how guidance will stack up versus investors' expectations.

The sustained improvement we have seen in the homecenter business over the last 6-9 months gives us confidence the positive momentum can continue in 2013 and should support some level of upside for both HD and LOW.

**Lowe's likely to show margin progress in 4Q, line review process evolving a bit.** We saw solid Holiday sales for Lowe's in 4Q including better in-stock levels and minimal markdown activity in this higher margin category. Our work suggests comp store sales were likely up in the 10-15% range for Lowe's in areas of this category during 4Q. This compares to weak Holiday sales and heavy markdown activity in the year ago period.

Our work also suggests Lowe's saw incremental benefit in 4Q from cost concessions throughout the line review process. Lowe's was able to complete more line reviews during the quarter and realize a greater percentage of sales from these line reviews versus 3Q (at higher margin).

We have seen LOW moderate/slow the pace of implementing merchandising changes from line reviews as well. This reduces the margin hit from these changes.

The feedback on the changes at Lowe's is continuing to show some slight progress (began to see this in September/October). We have seen Lowe's take steps to reverse some bad decisions made earlier in the line review process. We have seen the focus and pace of these line reviews moderating in some instances as well. This does not suggest a wholesale change in the process, just some areas of moderation.

It will be important to see if the focus of line reviews changes with the recent addition of a head merchant. We have seen LOW incrementally focused on margin rather than sales with the effort to this point. We are unsure if there is a significant shift in this strategy on the horizon from LOW.

We have seen some improvement in selling efforts at LOW. The improvement in selling efforts includes:

- Increased inventory in key categories and key SKUs for the Spring selling system versus the year ago period (seasonal and building materials; planned to continue in the Fall)
- Category resets are seeing comps improve month to month/faster turns
- Northlake resets are adding incrementally to the comp (more stores reset, performance continues to improve)
- Total line review process moving slower, and is less disruptive versus 90 days ago; quality and innovation are becoming focus points again

The line review process at Lowe's was extremely disruptive in 1H12 and into early 2H12. We are working to see how this process evolves, and if there can be benefit against these comparisons.

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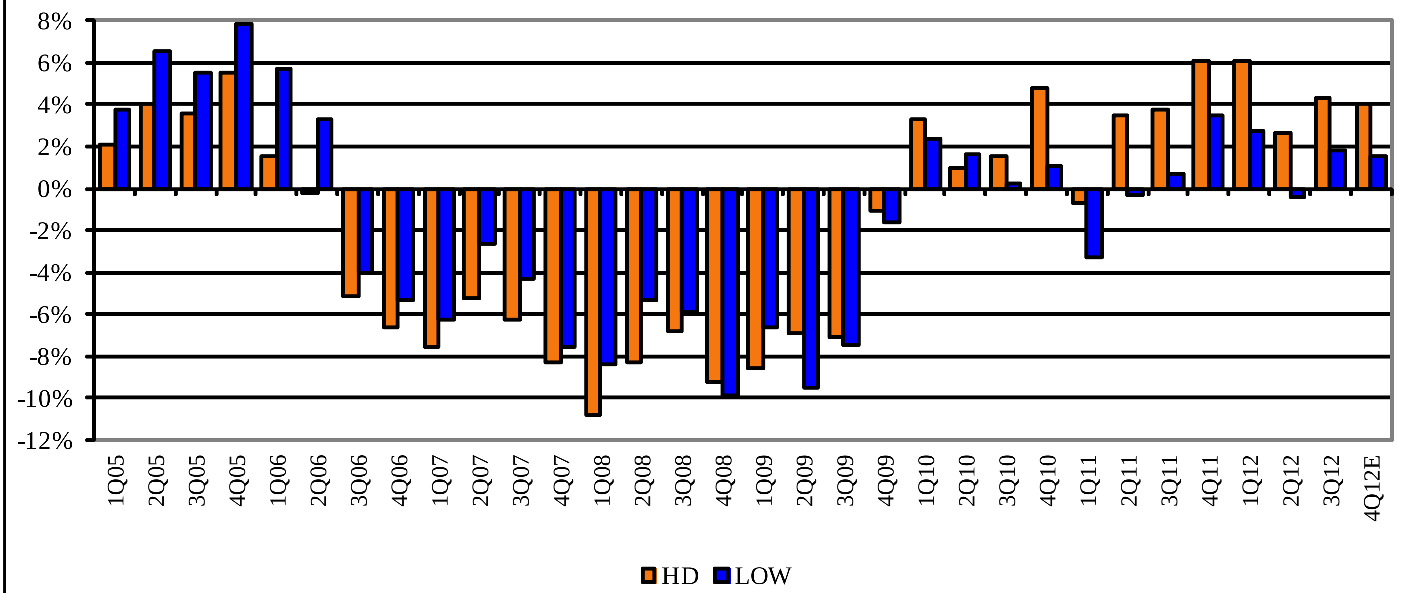
**Quarterly Comps, HD and LOW**




| | 1Q10 | 2Q10 | 3Q10 | 4Q10 | 1Q11 | 2Q11 | 3Q11 | 4Q11 | 1Q12 | 2Q12 | 3Q12 | 4Q12E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **HD (US)** | **3.3%** | **1.0%** | **1.5%** | **4.8%** | **-0.7%** | **3.5%** | **3.8%** | **6.1%** | **6.1%** | **2.6%** | **4.3%** | **4.0%** |
| *2-year* | *-2.7%* | *-3.0%* | *-2.8%* | *1.9%* | *1.3%* | *2.3%* | *2.7%* | *5.5%* | *2.7%* | *3.1%* | *4.1%* | *5.1%* |
| *3-year* | *-5.4%* | *-4.7%* | *-4.1%* | *-1.8%* | *-2.0%* | *-0.8%* | *-0.6%* | *3.3%* | *2.9%* | *2.4%* | *3.2%* | *5.0%* |
| **LOW (US)** | **2.4%** | **1.6%** | **0.2%** | **1.1%** | **-3.3%** | **-0.3%** | **0.7%** | **3.5%** | **2.7%** | **-0.4%** | **1.8%** | **1.5%** |
| *2-year* | *-2.1%* | *-4.0%* | *-3.7%* | *-0.3%* | *-0.5%* | *0.7%* | *0.5%* | *2.3%* | *-0.3%* | *-0.4%* | *1.3%* | *2.5%* |
| *3-year* | *-4.2%* | *-4.4%* | *-4.4%* | *-3.5%* | *-2.5%* | *-2.7%* | *-2.2%* | *1.0%* | *0.6%* | *0.3%* | *0.9%* | *2.0%* |
| **Average** | **2.9%** | **1.3%** | **0.9%** | **3.0%** | **-2.0%** | **1.6%** | **2.3%** | **4.8%** | **4.4%** | **1.1%** | **3.1%** | **2.8%** |

*Source: Company reports, CRC estimates*

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## Monthly Comp Store Sales

*note HD numbers reflect US stores only beginning February 2009

| | Feb-12 | Mar-12 | Apr-12 | May-12 | Jun-12 | Jul-12 | Aug-12 | Sep-12 | Oct-12 |
|---|---|---|---|---|---|---|---|---|---|
| HD | 7.2% | 5.8% | 5.6% | 3.6% | 0.2% | 3.8% | 3.0% | 5.2% | 4.6% |
| LOW | 5.0% | 3.0% | 0.0% | -2.1% | 0.4% | 0.7% | 0.4% | 3.4% | 1.3% |
| Avg | **6.1%** | **4.4%** | **2.8%** | **0.8%** | **0.3%** | **2.3%** | **1.7%** | **4.3%** | **3.0%** |
| HD-LOW | **2.2%** | **2.8%** | **5.6%** | **5.7%** | **-0.2%** | **3.1%** | **2.6%** | **1.8%** | **3.3%** |

| | Feb-11 | Mar-11 | Apr-11 | May-11 | Jun-11 | Jul-11 | Aug-11 | Sep-11 | Oct-11 | Nov-11 | Dec-11 | Jan-12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| HD | 2.8% | 1.2% | -4.0% | 0.8% | 5.7% | 4.0% | 4.5% | 3.4% | 3.4% | 1.4% | 7.1% | 10.0% |
| LOW | 2.7% | -1.9% | -8.3% | -2.7% | 0.0% | 2.2% | 1.4% | 0.3% | 0.4% | 0.2% | 3.2% | 7.0% |
| Avg | **2.8%** | **-0.4%** | **-6.2%** | **-1.0%** | **2.9%** | **3.1%** | **3.0%** | **1.9%** | **1.9%** | **0.8%** | **5.2%** | **8.5%** |
| HD-LOW | **0.1%** | **3.1%** | **4.3%** | **3.5%** | **5.7%** | **1.8%** | **3.1%** | **3.1%** | **3.0%** | **1.2%** | **3.9%** | **3.0%** |

| | Feb-10 | Mar-10 | Apr-10 | May-10 | Jun-10 | Jul-10 | Aug-10 | Sep-10 | Oct-10 | Nov-10 | Dec-10 | Jan-11 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| HD | -1.2% | 3.9% | 5.5% | -0.2% | 3.0% | 0.4% | 0.6% | 0.0% | 3.5% | 8.0% | 5.8% | 0.7% |
| LOW | -7.2% | 2.4% | 8.8% | 3.0% | 0.2% | 1.4% | 0.0% | -0.5% | 1.2% | 2.0% | 1.7% | -0.8% |
| Avg | **-4.2%** | **3.2%** | **7.2%** | **1.4%** | **1.6%** | **0.9%** | **0.3%** | **-0.3%** | **2.4%** | **5.0%** | **3.8%** | **-0.1%** |
| HD-LOW | **6.0%** | **1.5%** | **-3.3%** | **-3.2%** | **2.8%** | **-1.0%** | **0.6%** | **0.5%** | **2.3%** | **6.0%** | **4.1%** | **1.5%** |

| | Feb-09* | Mar-09 | Apr-09 | May-09 | Jun-09 | Jul-09 | Aug-09 | Sep-09 | Oct-09 | Nov-09 | Dec-09 | Jan-10 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| HD | -11.0% | -7.2% | -8.0% | -4.7% | -9.8% | -6.5% | -9.3% | -7.0% | -5.2% | 0.3% | -2.3% | -1.5% |
| LOW | -6.4% | -6.4% | -6.6% | -7.9% | -9.9% | -10.6% | -8.7% | -7.9% | -5.6% | -2.0% | -0.4% | -2.7% |
| Avg | **-8.7%** | **-6.8%** | **-7.3%** | **-6.3%** | **-9.9%** | **-8.6%** | **-9.0%** | **-7.5%** | **-5.4%** | **-0.9%** | **-1.4%** | **-2.1%** |
| HD-LOW | **-4.6%** | **-0.8%** | **-1.4%** | **3.2%** | **0.1%** | **4.1%** | **-0.6%** | **0.9%** | **0.4%** | **2.3%** | **-1.9%** | **1.2%** |

*HD 3q and 4q08 is on normal calendar*

| | Feb-08 | Mar-08 | Apr-08 | May-08 | Jun-08 | Jul-08 | Aug-08 | Sep-08 | Oct-08 | Nov-08 | Dec-08 | Jan-09 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| HD | -6.4% | -8.7% | -4.9% | -7.3% | -8.1% | -8.1% | -6.2% | -5.3% | -9.4% | -9.5% | -8.6% | -9.4% |
| LOW | -12.0% | -12.0% | -1.0% | -5.5% | -4.0% | -6.5% | -7.2% | -5.0% | -5.7% | -12.0% | -7.9% | -9.9% |
| Avg | **-9.2%** | **-10.4%** | **-3.0%** | **-6.4%** | **-6.1%** | **-7.3%** | **-6.7%** | **-5.2%** | **-7.6%** | **-10.8%** | **-8.3%** | **-9.7%** |
| HD-LOW | **5.6%** | **3.3%** | **-3.9%** | **-1.8%** | **-4.1%** | **-1.6%** | **1.0%** | **-0.3%** | **-3.7%** | **2.5%** | **-0.7%** | **0.5%** |

| | Feb-07 | Mar-07 | Apr-07 | May-07 | Jun-07 | Jul-07 | Aug-07 | Sep-07 | Oct-07 | Nov-07 | Dec-07 | Jan-08 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| HD | -7.4% | -5.0% | -9.3% | -3.1% | -5.4% | -6.8% | -5.0% | -7.3% | -6.3% | -6.6% | -7.2% | -10.8% |
| LOW | -9.0% | -1.0% | -10.0% | -1.8% | -3.6% | -2.3% | -1.0% | -5.0% | -6.0% | -4.0% | -9.0% | -11.0% |
| Avg | **-8.2%** | **-3.0%** | **-9.7%** | **-2.5%** | **-4.5%** | **-4.6%** | **-3.0%** | **-6.2%** | **-6.2%** | **-5.3%** | **-8.1%** | **-10.9%** |
| HD-LOW | **1.6%** | **-4.0%** | **0.7%** | **-1.3%** | **-1.8%** | **-4.5%** | **-4.0%** | **-2.3%** | **-0.3%** | **-2.6%** | **1.8%** | **0.2%** |

Note the above excludes calendar impacts when given

*Source: Company reports*

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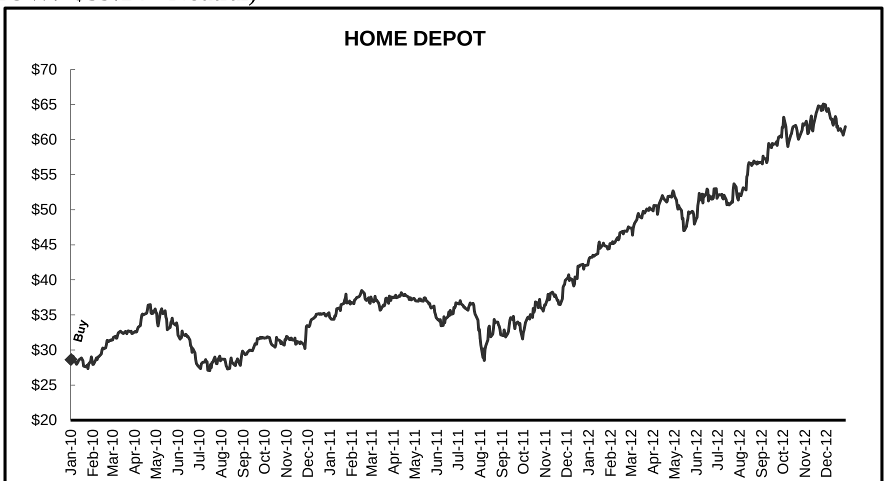
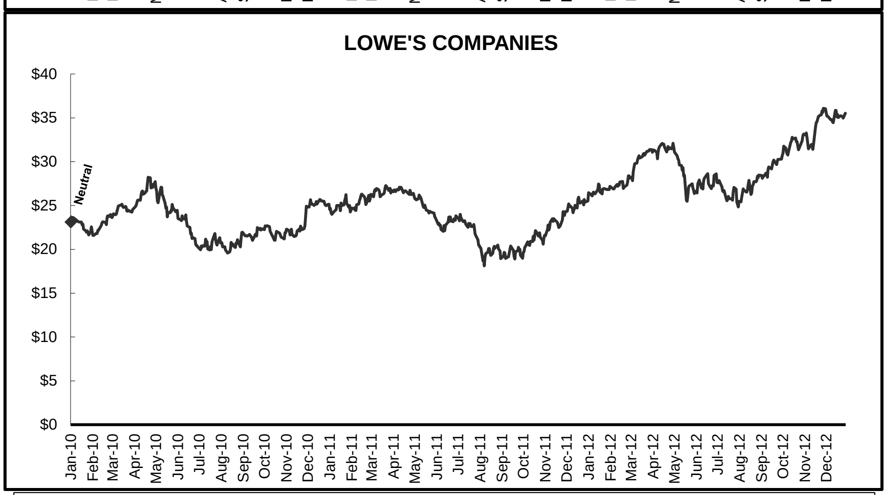
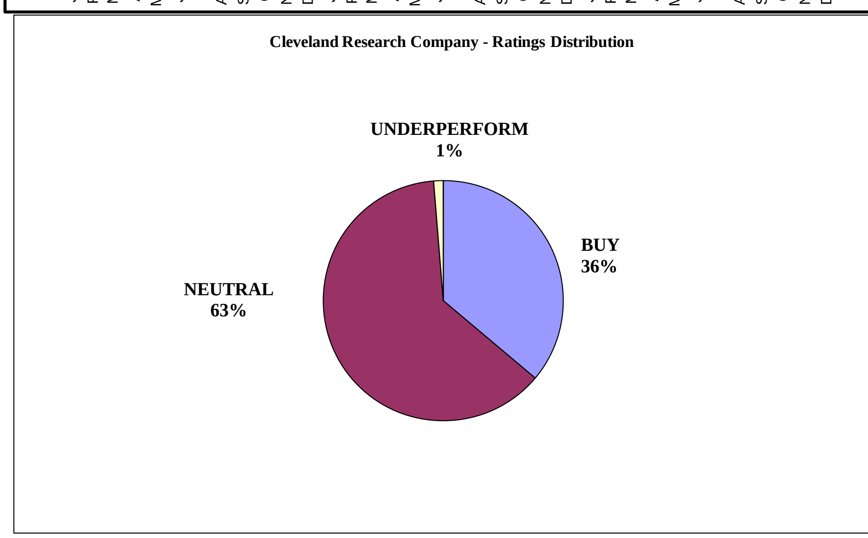
## APPENDIX

**Important Disclosures**

**Companies Mentioned in the Report:**
The Home Depot, Inc. (HD: $67.52 - Buy)
Lowe's Companies Inc. (LOW: $39.14 - Neutral)



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***Disclosures***

***Buy:*** *The stock's return is expected to exceed the market due to superior fundamentals and positive catalysts.*
***Underperform:*** *The stock's total return is expected to underperform the market due to weak fundamentals and a lack of catalysts.*
***Neutral:*** *The stock is expected to be in line with the market due to full valuation and/or a lack of catalysts.*
***Valuation and Risk:*** *Price targets are established under various valuation methods including P/E, P/S, EV/EBITDA on financial estimates based on forward earnings. Price targets are not established for every stock. The price target's effectiveness may be affected by various outside factors. Risk assessments can be found in the most recent research on these stocks.*

***Other Disclosures:*** *We, Eric Bosshard, CFA, Mark Herbek, CFA, and Tom Mahoney, CFA, certify that the views expressed in the research report(s) accurately reflect our personal views about the subject security(s). Further, we certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report(s). The analysts responsible for the preparation of this report have no ownership stake in this company. Cleveland Research Company provides no investment banking services of any type on this or any company. Proprietary research and Information contained herein which forms the basis for findings or opinions expressed by Cleveland Research Company may be used by Cleveland Research for other purposes in the course of compensated consulting and other services rendered to third parties.*