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### Home Depot (HD - \$24.98)

Despite reporting a 21% gain in per share profits for the third quarter, and a rise of 9% in total Company sales, the price of Home Depot dropped sharply as the market concentrated on a 2% decline in comparable store revenues. In our opinion, the latter represents only a temporary situation. Major changes in operating methods, the opening of additional stores in existing markets, and substantial remodeling of stores all reduced sales. While these steps resulted in a reduction of volume, however, they also resulted in higher profit margins. On balance, we regard the changes initiated by management as improvements which will increase earnings and strengthen Home Depot's competitive position substantially in coming months. Most significantly, as these benefits become apparent, we expect the shares will command a higher multiple.

In contrast to widely-held beliefs, the major portion of the negative influences holding back Home Depot's sales gains arise from internal actions rather than from increased competition. The company's activity in remodels and in replacing old inventories with new or substantially different lines of products, such as the addition of major appliances, has hindered sales. Clearance sales of discontinued items have increased traffic but have only partly offset the impact. On balance, the firm's major changes have probably reduced volume by 5%, in contrast to an impact of a maximum of a 1% reduction from new Lowes (LOW - \$39.16) stores. We expect employee morale to improve as new products and methods of operation become more familiar, and project a shift to positive sales from existing stores during the next two to three quarters.

We are increasing our earnings estimates for this year and next year as well. Profits seem likely to exceed \$1.55 per share for the current fiscal year and probably will rise by 18-20% next year to approximately \$1.85 per share. The price of Home Depot has fallen more than 50% from the \$52.60 high of the past twelve months, despite steady gains in earnings. At this point, we regard the stock price as unusually depressed, primarily because of misconceptions arising from a temporary situation. We continue to recommend purchase of Home Depot shares.

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