

# Waiting for a Bounce from the Lowe's

*November 8, 2011*



**Pershing Square Capital Management, L.P.**

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# Lowe's ("LOW")

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Recent stock price: \$21.50 <sup>(1)</sup>

Ticker: "LOW"

Div. Yield: ~2%

- ▶ **Lowe's (or the "Company") is a leading North American home improvement retailer**
  
- ▶ **Operates ~1,750 stores consisting of approximately 200mm ft<sup>2</sup> of selling space**
  - 99% of stores located in the US
  
- ▶ **Equity market capitalization of ~\$29bn**
  
- ▶ **Enterprise valuation of ~\$34bn**
  
- ▶ **Current free cash flow yield of ~8%**

(1) Based on stock price of \$21.54 as of November 4, 2011.

# Stock Price Performance: Last 5 Years

**Lowe's recent share price of \$21.50 is nearly 40% below its peak of ~\$35 in February 2007**



# Investment Highlights

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## Attractive retail category

- ▶ Limited internet risk relative to other retailers
- ▶ High gross margin retail category and diversified commodity risk
- ▶ Limited fashion risk
- ▶ Service component = consumer value proposition

## Good barriers to entry

- ▶ Home Depot and Lowe's are the central players in home center retail
- ▶ Home centers are low-cost providers, given scale and leverage with suppliers
- ▶ Limited risk of new entrants

## Cheap Valuation

- ▶ Lowe's trades at 6.5x depressed EBITDA and less than 13.5x depressed EPS
- ▶ Lowe's EBIT margin currently 7.5% only 70bps higher than its trough in 2009 at 6.8%
- ▶ Company believes normalized EBIT margins are 10%
- ▶ Company has maintained staffing to provide high service levels and be positioned for a recovery

## Investment Highlights *(cont'd)*

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### Extremely shareholder friendly capital allocation policy

- ▶ All free cash flow after dividends goes towards share repurchase
- ▶ Company is increasing leverage levels modestly to further accelerate buyback
- ▶ We expect the Company to buy back \$10bn to \$13bn of stock from 2012 to 2015
  - Equivalent to 35% to 45% of the current market cap of the Company

### Strong asset value and low financial leverage – limits downside

- ▶ Lease-Adjusted Net Debt / LTM EBITDAR = 1.6x
- ▶ Owns roughly 89% of its ~1,750 buildings
- ▶ \$23bn gross book value of land and buildings, or ~65% of Lowe's enterprise value

# Business Overview

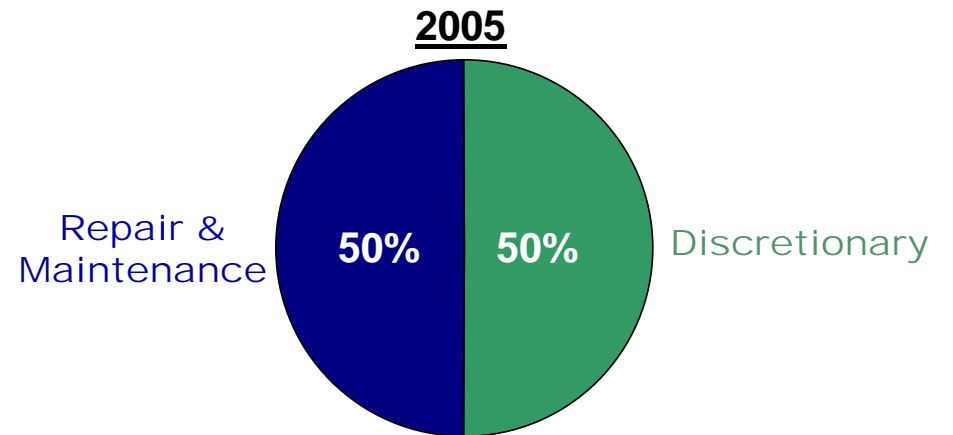
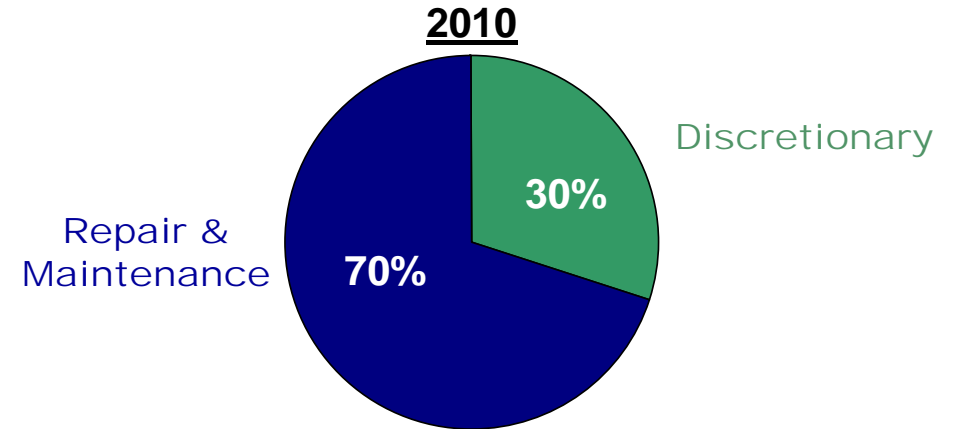
# Lowe's Business Snapshot



## Overview of Lowe's

- ▶ 2<sup>nd</sup> largest home improvement retailer
- ▶ Typical customer shops at Lowe's three to four times per year and spends ~\$62 per transaction
- ▶ Each store averages ~\$28mm in revenue
- ▶ LTM Sales/ft<sup>2</sup> is \$246

## Revenue Mix



*Sales today are significantly more Repair & Maintenance items than Discretionary items*



# Why Do Consumers Shop at Home Centers?

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## Valuable Customer Service

- ▶ Helps customers identify the exact products they need (e.g., replacement parts)
- ▶ Consults with customers on complex remodeling projects
- ▶ Provides installation services

## One-Stop Shopping

- ▶ Home improvement purchases are typically project-oriented (e.g., bathroom remodel)
  - Consumers buy across categories (paint, plumbing, flooring, etc.) making one-stop shopping ideal
- ▶ Home centers' big-box layout allows for ~40,000+ SKUs
  - Product selection can't be matched by general merchandise retailers

## Instant Satisfaction

- ▶ Customers can purchase products and take them home from the store immediately

## Convenience

- ▶ Lowe's has ~1,750 stores across 50 U.S. states

# Why Do Consumers Shop Online?

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**Online retailing has become a headwind for most brick-and-mortar retailers over the recent years. Online shopping is most appealing to consumers when the following conditions apply:**

- ✓ **Product is relatively high-priced (i.e., sales tax savings are more material)**
- ✓ **Product is not needed immediately**
- ✓ **Shipping cost is low**
- ✓ **Shipping is unlikely to damage the product**
- ✓ **Professional installation is not needed**
- ✓ **Item is not purchased as part of a larger project**
- ✓ **End-user of the product is making the purchasing decision**

***We believe that the home centers face limited risk from online shopping because the majority of products they sell do not meet most of these conditions***

# Home Improvement Retail: Limited Internet Risk

**We believe that only 10% of Lowe's revenues face a high risk of competition from online retailers**

Category	Est. % of Rev.	Product Example	Threat of Internet Competition	Reason
<b>Lawn &amp; Garden</b>	13 %	Grills, mowers, garden chemicals	Limited	Shipping issues
<b>Electrical</b>				
Light Bulbs	1 %		High	New LED bulbs ship well, high ticket
Technical Lighting	1 %	Switches, dimmers	Limited	Low ticket
Ceiling Fans	2 %		Moderate	
<b>Plumbing</b>				
Pipes/Fitting	3 %		Limited	Contractor purchase, project-based
Faucets	2 %		Moderate	High ticket, ships well
Large Fixtures	2 %	Tubs, sinks	Limited	
<b>Paint &amp; Accessories</b>	9 %		Limited	Paint not ship well, project-based
<b>Floor &amp; Wall</b>				
Flooring	4 %		Limited	Shipping issues
Wall Storage	2 %	Closets storage	Limited	Shipping issues
Wall Décor	2 %	Curtain rods	High	Higher ticket, ships well
<b>Hardware</b>				
Power Tools	3 %	Electric drills, screwdrivers	High	Higher ticket, ships well, not project-based
Handtools	3 %	Manual hammer, screwdriver	Limited	Low-ticket, project-based
Hardware Accessories	6 %	Nails, bolts, nuts	Limited	Low-ticket, project-based
Door Lock Sets	1 %	Front door knobs, deadbolts	High	High ticket, ships well
<b>Windows &amp; Doors</b>	11 %		Limited	Shipping issues
<b>Building Materials</b>	20 %	Lumber, insulation, roofing, concrete	Limited	Contractor purchase, project based, shipping issues
<b>Appliances</b>				
Installable Appliances	8 %	Washer/Dryer, A/C, stove, refrig.	Limited-Moderate	Service component
Non-Installable Appliances	2 %	Small appliances	High	High ticket, no service component, ships well
<b>Kitchen</b>	5 %	Cabinets	Limited	Installation, shipping issues

<b>Limited Risk</b>	<b>82 %</b>
<b>Moderate Risk</b>	<b>8 %</b>
<b>High Risk</b>	<b>10 %</b>

Note: Limited-Moderate category counts 50% towards limited, 50% towards moderate

# Lowe's Financials: Margins Down Significantly

Lowe's sales/ft<sup>2</sup> is 25% less than peak levels achieved nearly six years ago. EBIT margins are ~350bps below peak margins achieved nearly five years ago

	2005	2006	2007	2008	2009	2010	LTM
<b>Revenue (\$ in B)</b>	\$43.2	\$46.9	\$48.3	\$48.2	\$47.2	\$48.8	\$48.8
<i>Growth</i>	19 %	9 %	3 %	(0)%	(2)%	3 %	(0)%
<b>EBIT Margin</b>	10.8 %	11.0 %	9.7 %	7.9 %	6.8 %	7.4 %	7.5 %
<b>Sales / Ft<sup>2</sup></b>	\$328	\$316	\$292	\$267	\$249	\$250	\$246
<i>Growth</i>	5 %	(4)%	(8)%	(8)%	(7)%	1 %	(1)%
<i>% of Peak</i>	100 %	96 %	89 %	82 %	76 %	76 %	75 %
<b>SSS Growth</b>	6.1 %	0.0 %	(5.1)%	(7.2)%	(6.7)%	1.3 %	(0.1)%
<b>Units</b>	1,234	1,385	1,534	1,638	1,710	1,749	1,753
<i>Growth</i>	14 %	12 %	11 %	7 %	4 %	2 %	0 %

## LOW Outperformed HD for Most of the Last Decade...

**Lowe's level of same-store sales growth outpaced Home Depot's each year from 2001 to 2008**

### Same-Store Sales Growth

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Lowe's	1.2 %	2.4 %	5.8 %	6.7 %	6.6 %	6.1 %	0.0 %	(5.1)%	(7.2)%
Home Depot	4.0 %	0.0 %	(0.5)%	3.7 %	5.1 %	3.1 %	(2.8)%	(6.7)%	(8.7)%
Lowe's - Home Depot	(2.8)%	2.4 %	6.3 %	3.0 %	1.5 %	3.0 %	2.8 %	1.6 %	1.5 %

*Note: Home Depot same-store sales growth figures are for the entire company only, as Home Depot did not consistently disclose U.S.-only same-store sales growth figures during the period from 2000 to 2008.*

## ...But Now LOW is the Underperformer

**Lowe's level of same-store sales growth has underperformed Home Depot's for eight out of the last ten quarters**

### Same-Store Sales Growth

	Q1 '09	Q2 '09	Q3 '09	Q4 '09	Q1 '10	Q2 '10	Q3 '10	Q4 '10	Q1 '11	Q2 '11
Lowe's	(6.6)%	(9.5)%	(7.5)%	(1.6)%	2.4 %	1.6 %	0.2 %	1.1 %	(3.3)%	(0.3)%
Home Depot - U.S. Only	(8.6)%	(6.9)%	(7.1)%	(1.1)%	3.3 %	1.0 %	1.5 %	4.8 %	(0.7)%	3.5 %
Lowe's - Home Depot	2.0 %	(2.6)%	(0.4)%	(0.5)%	(0.9)%	0.6 %	(1.3)%	(3.7)%	(2.6)%	(3.8)%

### Potential Causes of Recent Underperformance:

- ▶ **Strength of HD's current operational execution**
  - Strong regional-level merchandising
  - Post Bob Nardelli, invigorated management team under CEO Frank Blake
- ▶ **Lowe's product mix is more discretionary than Home Depot's**
- ▶ **Home Depot currently doing well with the basic repair customer versus Lowe's more fashion-oriented customer**

# Trading Multiples Reflect Underperformance

Based on its recent underperformance, Lowe's trades at a discount to Home Depot on both LTM and 2012E multiples

	LTM		Consensus 2012E	
	EV/EBITDA	P/E	EV/EBITDA	P/E
Lowe's	6.5 x	13.3 x	6.3 x	12.2 x
Home Depot	8.5 x	16.1 x	7.8 x	13.8 x

Despite the valuation discount relative to HD, we believe Lowe's long history of same-store sales outperformance suggests that recent underperformance is more likely temporary rather than structural

## Memo: Capitalization

	Lowe's	Home Depot
Stock Price	\$21.50	\$37.00
Diluted Shares	1,328	1,577
<b>Market Cap</b>	<b>\$28,552</b>	<b>\$58,349</b>
Plus: Debt	6,620	10,775
Less: Cash & Investments (1)	(1,423)	(2,551)
<b>Enterprise Value</b>	<b>\$33,749</b>	<b>\$66,573</b>
Dividend Yield	2.0 %	2.7 %

(1) For Lowe's, Cash & Investments are net of restricted cash balances.

# Lowe's Management is Bullish...

At last year's analyst day, management guided to \$3.40 of EPS in 2015, driven by a 4% average growth rate in same-store sales, a 10% EBIT margin, and an \$18bn share repurchase program (2011 to 2015)

<b>Income Statement</b>			
Dollars in Millions Except EPS			
	2010E	Roadmap to 2015	2015E
Sales	\$ 48,900	5.7% annual average growth	\$ 64,400
EBIT %	7.14%	57 bp annual average increase	10.0%
Net Earnings	\$ 1,970	13% annual average growth	\$ 3,600
EPS	\$ 1.385	~ 20% annual average growth	\$ 3.40

Note: 2010 figures represent mid-point of the guided range of our outlook.  
E = Estimate  
bp = basis point

Recent Price	\$21.50
2015 EPS	\$3.40
Price / 2015 EPS	6.3 x

Note: This page is taken from Lowe's investor presentation dated November 30, 2010. Red highlights added for emphasis.



## ...And is Buying Back Stock Aggressively

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Management plans to use all free cash flow after dividends to repurchase stock and will increase leverage to 1.8x Lease Adjusted Net Debt / EBITDAR from 1.6x. We estimate share repurchases will be ~\$10bn to \$13bn from 2012 to 2015

- ▶ **At the current share price, management could repurchase ~35% to 45% of the Company between 2012 and 2015**
- ▶ **In the first half of 2011, management repurchased nearly \$2.4B of shares at an average price of ~\$25**
  - Repurchased ~7% of the current share base
- ▶ **Share repurchases may accelerate annual core earnings growth by 8% to 10% from 2012 to 2015**
- ▶ **Current interest rate environment makes debt financing an attractive source of capital for share repurchases**

Valuation

# Valuation Assumptions

**Our estimates are more conservative than management's 2015 targets**

	Management Targets	Pershing Square Estimates		
		Low	Mid	High
<b>2012E to 2015E CAGR:</b>				
Home Improvement Market	~ 3.0 %	0.0 %	1.5 %	3.0 %
Impact of Share Gains	~ 1.0 %	0.0 %	1.0 %	1.0 %
Same-Store Sales	4.0 %	0.0 %	2.5 %	4.0 %
2015 EBIT Margin	10.0 %	7.3 %	8.3 %	9.3 %
2015 EPS	\$3.40	\$2.00	\$2.60	\$3.20
% Increase from LTM EPS	~110%	~25%	~60%	~100%

***Drivers of share gains:***

- ✓ Growth from internet site
- ✓ Gains from Mom & Pop dealers
- ✓ Gains from Sears
- ⊗ Losses from cannibalization

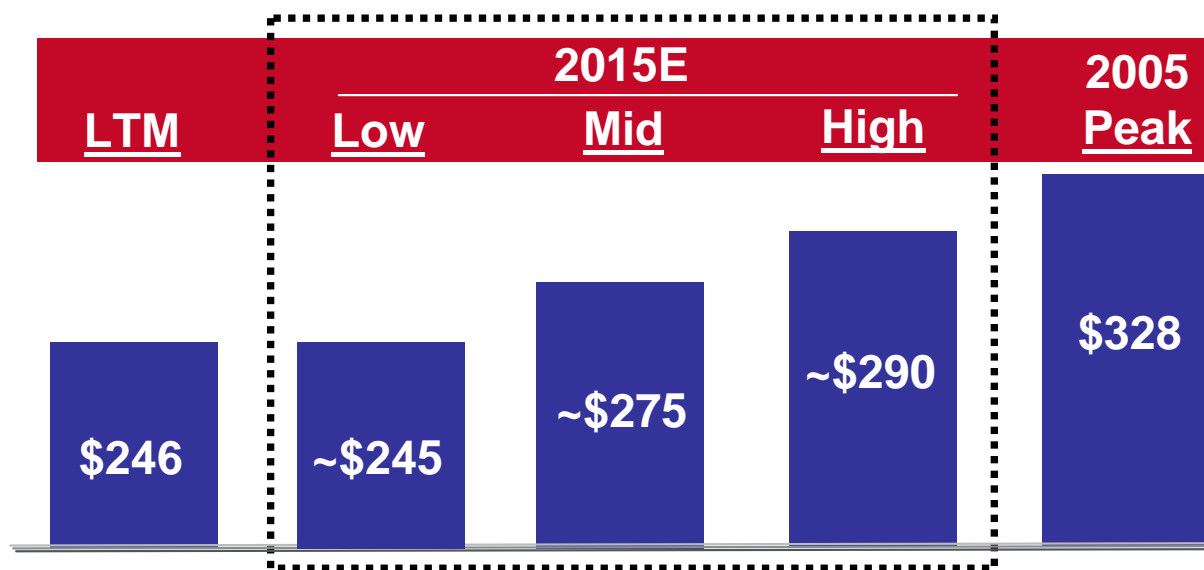
*Pershing Square Mid and High cases reflect our view of the most likely outcomes*

Note: Management targets based on November 2010 analyst day and annualized same-store sales growth reflected management estimates for 2011E to 2015E.

# Sales/ft<sup>2</sup>

Sales/ft<sup>2</sup> is still 25% below 2005 peak levels six years later. We believe sales/ft<sup>2</sup> could increase materially by 2015 and still be meaningfully below inflation-adjusted peak levels reached in 2005

Sales/ft<sup>2</sup>:



2012E to 2015E Same-Store Sales CAGR

0%

~2.5%

~4%

% of 2005 Peak

~75%

~85%

~90%

% of 2005 Inflation-Adjusted Peak

~55% to 65%

~65% to 75%

~70% to 80%

Note: Inflation-adjusted peak based on a 1% to 2% annual inflation rate.

# EBIT Margins

**In our Mid and High cases, we believe EBIT margins could be ~8.3% to 9.3%. In our Low case, if same-store sales remain flat, we believe Lowe's can maintain current EBIT margins through cost reductions**

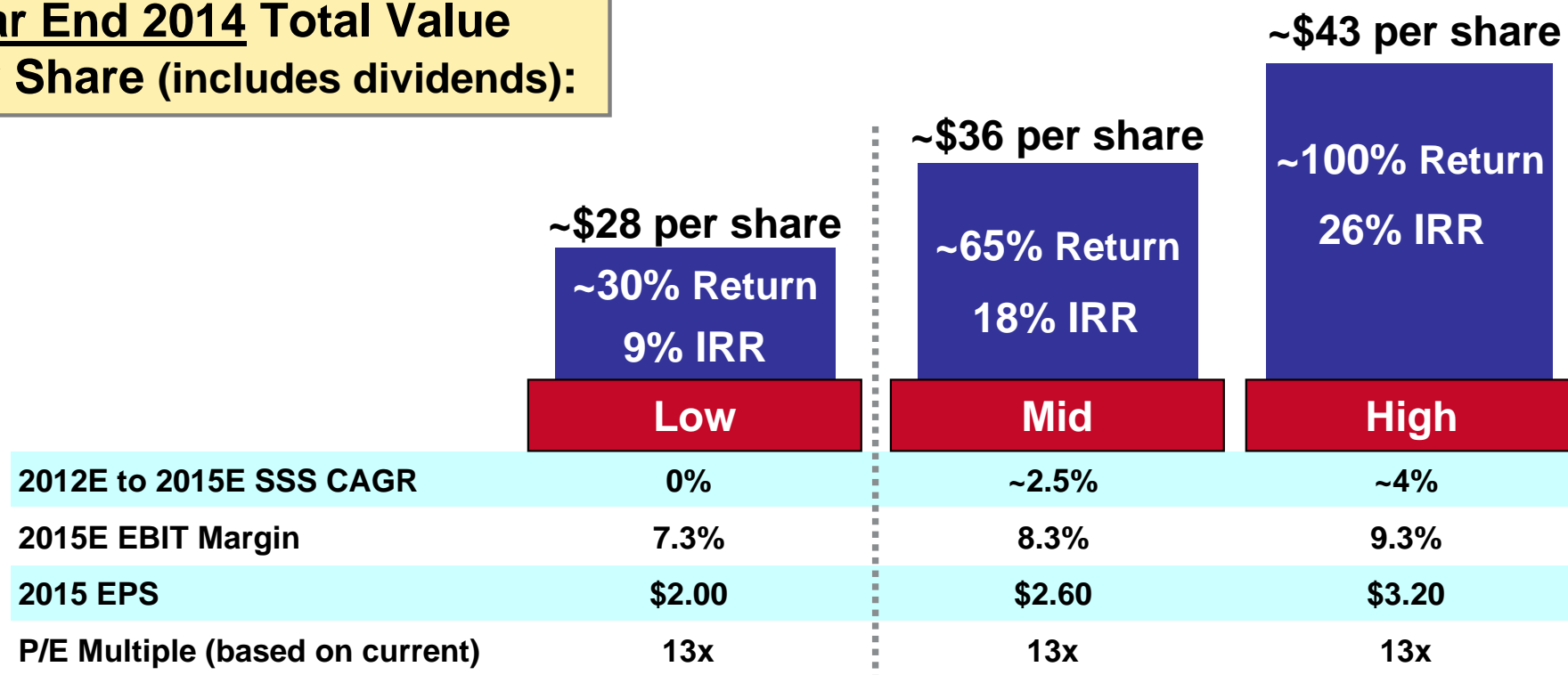
	<u>Low</u>	<u>Mid</u>	<u>High</u>
<b>2012E to 2015E Same Store Sales CAGR</b>	<b>0.0%</b>	<b>2.5%</b>	<b>4.0%</b>
<b>Est. Annual EBIT Margin Improvement</b>	<b>0bps</b>	<b>25bps</b>	<b>50bps</b>
<b>2011E EBIT Margin</b>	<b>7.3 %</b>	<b>7.3 %</b>	<b>7.3 %</b>
<b>Plus: Total Est. EBIT Margin Improvement</b>	<b>0.0 %</b>	<b>1.0 %</b>	<b>2.0 %</b>
<b>2015E EBIT Margin</b>	<b>7.3 %</b>	<b>8.3 %</b>	<b>9.3 %</b>

*Note: Current gross margins are partially elevated by a favorable mix of higher-margin, lower-ticket items. As sales recover, we expect a slight gross margin headwind, offset by positive operating leverage. Management estimates each 1% of same store sales growth above 1% will result in 20bps of operating expense leverage.*

# Valuing Lowe's

We believe 2015 EPS will likely be between \$2.60 to \$3.20. At a 13x P/E, the total value per share at year end 2014 is \$36 to \$43. If same-store sales remain flat for the next several years, year end 2014 total value per share is \$28, driven largely by share repurchases

## Year End 2014 Total Value Per Share (includes dividends):



Note: Based on ~1% annual net unit growth. Includes ~\$1.80 of dividends received between 2012 and 2014.

# Conclusion

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- ▶ **We think Lowe's is a good business in an attractive retail category**
  - However, sentiment is poor because of the Company's more recent underperformance relative to Home Depot
  - We think this underperformance is more temporary than structural
- ▶ **The current stock price is not factoring in a sales recovery, but we believe one is likely in the next several years**
- ▶ **Even if no sales recovery occurs, we believe downside is limited**
  - Minimal financial leverage, limited lease leverage, cheap stock
- ▶ **Aggressive share repurchase program is a catalyst**
  - Lowe's has ~8% current cash earnings yield
  - The Company is returning all cash earnings to shareholders in the form of buybacks and dividends
  - Investors are effectively paid to wait for a recovery