

J.C. Penney Co., Inc.

The Little Engine That Could or a Train Wreck? Year #1 Complete w/ "Return to Growth" Timeline the Key

JCP's 4Q results (-\$2.51 EPS vs. JPM -\$0.50) post close arguably could not have been worse (SSS down 31.7%; GPM down 1,000bps), and while Year #1 of the transformation is complete (*taking the worst is behind us view*), visibility into Year #2 appears less than clear. **Importantly, on the conference call CEO Johnson would no longer confirm (1) "Return to Growth" guidance for FY13 provided just three months ago on the 3Q call (i.e. "2013, just around the corner, is the year we expect to return to growth"), and (2) JCP's ability to self-fund the transformation ("while still our intention, the customer will ultimately dictate").** While the company ended the year with \$930M of cash on hand, it is imperative that top-line trends stabilize in 1Q as working capital benefits (inventory cuts, payables terms) are not sustainable, in our view, with our 1Q13 model (-10% SSS embedded) pointing to a \$400-500M cash flow burn in 1Q alone on our math. **Looking ahead we are reducing our estimates, modeling an EPS loss of \$3.50 in FY13 with breakeven (ex pension) not reached until 2015 in our view and reducing our Dec 2013 price target to \$15 (from \$18).**

- **5 Key Takes from the 5pm Earnings Call.** Five Key Takeaways: (1) **"Return to Growth" Not Confirmed for 2013:** While CEO Johnson stated he is committed to returning to growth longer term (sooner than later) he would not confirm a specific timeline (FY13 cited on its 3Q cal in Nov), citing greater visibility post the Joe Fresh and home transformation in May. (2) **"Self-Funding" the Transformation:** While CFO Hannah spoke to a continued "intention" to self-fund the transformation out of cash from operations (last confirmed on the Nov 3Q call), the key addition tonight was that "the customer and net traffic will ultimately decide this for us." (3) **Return to Sales:** On the rationale for the 4Q strategic pricing change, CEO Johnson spoke to the customers' need to deliver value to her family, so JCP is returning to sales and coupons (rewards members). (4) **Components of the 4Q Comp (-31.7%):** Traffic was down -17% YOY (vs. -12% in 3Q) with store conversion down -10% YOY (consistent with 3Q). (5) **Promotional Plan: Private vs. National Markdowns:** While JCP has returned to a three-tiered pricing structure (in-season clearance the key change), promotions going forward will be selective to private label brands and national brands that choose to participate.

Neutral

JCP, JCP US

Price: \$21.16

▼ **Price Target: \$15.00**
Previous: \$18.00

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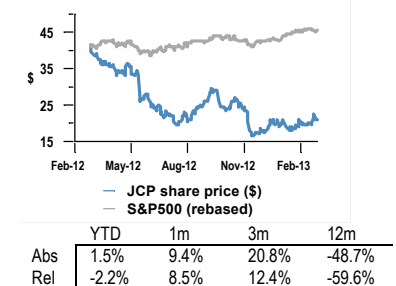
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Price Performance



J.C. Penney Company, Inc. (JCP;JCP US)

FYE Jan	2010A	2011A	2012A	2013E	2013E	2014E	2014E	2015E	2015E
				(Prev)	(Curr)	(Prev)	(Curr)	(Prev)	(Curr)
EPS (Operating) (\$)									
Q1 (Apr)	0.25	0.28	(0.39)	-	-	-	-	-	-
Q2 (Jul)	0.06	0.06	(0.50)	-	-	-	-	-	-
Q3 (Oct)	0.19	(0.67)	(1.04)	-	-	-	-	-	-
Q4 (Jan)	1.13	0.19	(2.44)	-	-	-	-	-	-
FY	1.59	(0.12)	(4.37)	(1.49)	(3.50)	0.01	(1.80)	1.50	(0.46)
P/E FY	13.3	NM	NM	NM	NM	42.3	NM	14.1	NM
Adjusted EPS FY (\$)	2.28	1.71	(3.45)	(1.00)	(3.01)	0.50	(1.31)	1.50	0.03
Bloomberg EPS FY (\$)	1.06	1.66	1.21	-	(1.65)	-	(0.67)	-	0.84

Source: Company data, Bloomberg, J.P. Morgan estimates. Note: Operating FY EPS estimates include non-cash pension charge and adjusted EPS excludes non-cash pension charge.

Company Data

Price (\$)	21.16
Date Of Price	27 Feb 13
52-week Range (\$)	41.73 - 15.69
Mkt Cap (\$ mn)	4,576.91
Fiscal Year End	Jan
Shares O/S (mn)	216
Price Target (\$)	15.00
Price Target End Date	31 Dec 13

See page 7 for analyst certification and important disclosures.

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- **4Q P&L Review: Just When You Thought It Couldn't Get Worse . . .** JCP reported 4Q EPS of (\$2.51) GAAP (-\$1.95 adjusted ex-pension) vs. our estimate of -\$0.50 (Street of -\$0.24). Breaking down the P&L, 4Q results showed further deterioration in same-store sales trends to -31.7% in 4Q from -26.1% in 3Q and -20% in 1H driven by traffic of -17% YOY and conversion down -10%. Total sales came in at \$3.88bil, or -28.4% YOY (SSS of -31.7%) vs. our model of \$3.86bil, or -28.7% YOY (SSS of -33.7%). EBIT margin declined to -12.4% given a GPM decline of 1019bps (23.8% vs. JPM 30.5% down 348bps) and SG&A deleverage of 637bps (\$ down -10% year-over-year vs. JPM -13.1%). **Breaking down the gross margins, everyday selling margins benefited GPM by 80bps (76% mix of biz, at 44.7% selling margins) offset by (1) a higher mix (24% of biz) of clearance merchandise (-430bps headwind), (2) clearance selling margin impact of -120bps (-0.6% selling margins), (3) cost concessions of -60bps, and (4) other of -110bps with LY GPMs adjusted 380bps for pricing changes (JPM using 4Q11 adjusted GPM of 34%).** Additional line item deviations in the P&L included an income tax benefit of \$250mil (JPM at \$65mil) slightly offset by higher interest expense of \$57 mil (JPM at \$53mil) in the quarter.
- **. . . Timing of the "Return to Growth" Uncertain with Reduced FY13 Visibility.** In Q&A CEO Johnson would not confirm a return to growth in FY13, commenting that the customer will dictate the timeline, but launch of new shops (particularly Joe Fresh and Home in May) will aid the transition (reining back specific FY13 return to growth comments made on 11/09). **On recent trends, management spoke to flat YOY traffic on Valentine's Day and President's Day weekend, with strong conversion early in the year despite inventories down YOY—something we will be monitoring in stores closely.** Importantly, JCP changed its pricing structure back to three tiers (EDV, In-Season Clearance, Final Clearance) in October with CEO Johnson speaking to coupons for rewards customers, and promotions exclusively within private label brands and select national brands that elect to participate. JCP also spoke to optimism regarding a new marketing campaign (launched three weeks ago by Sergio Zyman from Coca-Cola). **Given a likely choppy start to 1Q we do not foresee either (1) a return to positive comps in FY13, modeling SSS down 5% (with -10% embedded in 1Q), nor a return to positive EPS (modeling -\$3.50).**
- **Balance Sheet Review: Self-Funding the Intention, but Not a Certainty.** As of 4Q-end, JCP has \$930M of cash & equivalents on hand vs. guidance for \$1B, and it has yet to tap its \$1.75B revolving line of credit. **Despite a continued intention to "self-fund" the transformation, a draw-down of the revolver appears increasingly likely, with JCP posturing toward a move as it builds its shops out this spring.** When asked on the earnings call, CFO Hannah stated that customer traction will ultimately decide whether the transformation will be self-funded. JCP continues to manage its inventories, ending the quarter at \$2.3B (-19.7% growth YOY) versus a -28.4% sales decline. On leverage, JCPenney's debt-to-capital ratio is 48.5%, slightly higher than 3Q's 45.8%. **Of note, accounts payables to inventory stood at 49.6%, up from 35% last year as the company attempts to more closely align the company's payment strategy to its inventory strategy.** Similarly, the company had an \$85M deferral of vendor payments into 2013, also as part of aligning the company's inventory and purchasing strategy along industry-standard terms (select vendors were paid the \$85M the first week of 1Q).

- **Reducing Estimates and Dec 2013 Price Target to \$15 (from \$18).** Our FY13 model assumes EPS of (\$3.50) EPS (-3.01 ex pension) assuming SSS -5.0% (2H weighted with SSS down 10% in 1Q), GPM +115bps, and SG&A \$ down ~\$295M (equating to \$900M of reduction in FY12/13 combined). **In light of long-term model changes (breakeven now anticipated in FY15) and lack of top-line visibility, we are reducing our Dec 2013 PT to \$15 reflecting 19x our 2014 EBITDA (7.5x 2015 given depressed 2013/2014 earnings profile).**

Table 1: JC Penney 4Q Results vs. JPMorgan

\$ in Millions (except per share)	JPMorgan	Actual
Same Store Sales	(33.7%)	(31.7%)
Total Revenue	\$3865.8	\$3884.0
Gross Margin %	30.5%	23.8%
Gross Profit Margin (bps YOY)	-348bps	-1019bps
SG&A Dollar Growth (YOY)	-13.1%	-10.0%
SG&A (as a % of sales) bps YOY	+477bps	+637bps
Operating EBIT Margin	-2.8%	-12.4%
Interest & Debt Expense	\$52.8	\$57
Tax Rate	37.5%	31.2%
Earnings Per Share (EPS)	(\$0.50)	(\$2.51)

Source: Company reports and J.P. Morgan estimates.

Table 2: JC Penney EPS Surprise History (Actual versus Street)

Quarter	Date Reported	Actual	Street	Delta	Result
1Q05	5/17/2005	\$0.64	\$0.58	\$0.06	Beat
2Q05	8/16/2005	\$0.44	\$0.38	\$0.06	Beat
3Q05	11/15/2005	\$0.94	\$0.86	\$0.08	Beat
4Q05	2/16/2006	\$1.71	\$1.66	\$0.05	Beat
1Q06	5/11/2006	\$0.87	\$0.84	\$0.03	Beat
2Q06	8/10/2006	\$0.72	\$0.71	\$0.02	Beat
3Q06	11/9/2006	\$1.24	\$1.17	\$0.07	Beat
4Q06	2/22/2007	\$1.99	\$2.01	(\$0.02)	Miss
1Q07	5/17/2007	\$1.02	\$1.03	(\$0.01)	Miss
2Q07	8/16/2007	\$0.78	\$0.78	(\$0.00)	Meet
3Q07	11/15/2007	\$1.00	\$1.01	(\$0.01)	Miss
4Q07	2/21/2008	\$1.88	\$1.76	\$0.12	Beat
1Q08	5/15/2008	\$0.53	\$0.50	\$0.03	Beat
2Q08	8/15/2008	\$0.50	\$0.51	(\$0.01)	Miss
3Q08	11/14/2008	\$0.53	\$0.52	\$0.01	Beat
4Q08	2/20/2009	\$0.97	\$0.92	\$0.05	Beat
1Q09	5/15/2009	\$0.11	\$0.11	\$0.00	Meet
2Q09	8/14/2009	\$0.00	(\$0.01)	\$0.01	Beat
3Q09	11/13/2009	\$0.14	\$0.14	\$0.00	Meet
4Q09	2/19/2010	\$1.02	\$0.82	\$0.20	Beat
1Q10	5/14/2010	\$0.25	\$0.25	(\$0.00)	Meet
2Q10	8/13/2010	\$0.11	\$0.11	\$0.00	Meet
3Q10	11/12/2010	\$0.19	\$0.17	\$0.02	Beat
4Q10	2/25/2011	\$1.17	\$1.16	\$0.01	Beat
1Q11	5/16/2011	\$0.29	\$0.28	\$0.01	Beat
2Q11	8/12/2011	\$0.07	\$0.13	(\$0.06)	Miss
3Q11	11/14/2011	\$0.11	\$0.11	\$0.00	Met
4Q11	2/24/2012	\$0.74	\$0.67	\$0.07	Beat
1Q12	5/15/2012	(\$0.25)	(\$0.06)	(\$0.19)	Miss
2Q12	8/10/2012	(\$0.37)	(\$0.23)	(\$0.14)	Miss
3Q12	11/9/2012	(\$0.93)	(\$0.16)	(\$0.77)	Miss
4Q12	2/27/2013	(\$2.51)	(\$0.24)	(\$2.27)	Miss

Source: Company reports and J.P. Morgan estimates.

Valuation

We are lowering our December 2013 price target to \$15 (from \$18), which reflects 19x our 2014E EBITDA. Given the depressed nature of 2013/2014 earnings we note it also reflects 7.5x our 2015E EBITDA (longer term view). Importantly, top-line trends in 2012 (down ~25%+) reflect the structural pricing change implemented in February 2012 with roughly 500bps+ of potential EBIT opportunity longer term (2015 and beyond) if the top line is stabilized. While management is in the midst of a multiyear turnaround (goal for FY13 stabilization), we believe our price target is reasonable given uncertainty around the timing of top-line stabilization.

Investment Thesis

Taking a deep dive approach, we have built a bottom-up roadmap for the top line and margins over the next five years and believe the story at JCPenney is not broken but has been constrained. Looking ahead, near-term top-line prospects are likely to remain lackluster given a structural pricing change (EDLP vs. layered discounting in the past). In our view, new CEO Ron Johnson has been successful at incrementally improving the JCP shopping experience (less inventory, improved sightlines), but this represents only the first step. The key will be content changes ahead with 100 shop-in-shops launched in stores through 2015 and 17 new brands (including Tourneau, Joe Fresh, and Bodum) announced to date and more to come. Moving down the P&L, the company's longer term (2015) EBIT margin target (though not a ceiling) stands at 13.0% (above prior peak of 9.5%).

Risks to Rating and Price Target

The economic climate, particularly the employment picture, can affect consumer spending and the department store industry. Therefore a decline in household spending could cause sales trends to decrease below our current assumptions, rendering our estimates too low and pushing out the timeline for the turnaround story at JCPenney. Competitively, an increased promotional environment, particularly from peers Kohl's and Macy's could lead to excess inventory in the channel and higher markdowns negatively impacting gross margin more than we are modeling. JCP's turnaround is proving more challenging than anticipated, with uncertainty around the strategy driving volatility, but noting that a reversal in top-line trends could lead to material upside for current estimates.

J.C. Penney Co., Inc.: Summary of Financials

Income Statement - Annual	FY12A	FY13E	FY14E	Income Statement - Quarterly	1Q13E	2Q13E	3Q13E	4Q13E
Revenues	12,985	12,174	12,661	Revenues	-	-	-	-
COGS	8,919	8,221	8,230	COGS	-	-	-	-
Gross profit	4,066	3,953	4,431	Gross profit	-	-	-	-
SG&A	4,506	4,210	4,105	SG&A	-	-	-	-
Operating income	(1,310)	(989)	(403)	Operating income	-	-	-	-
EBITDA	(767)	(449)	-	EBITDA	-	-	-	-
Interest, net	226	219	219	Interest, net	-	-	-	-
Other Income	-	-	-	Other Income	-	-	-	-
Pretax income	(1,536)	(1,208)	(622)	Pretax income	-	-	-	-
Income taxes	(551)	(441)	(227)	Income taxes	-	-	-	-
Tax rate	35.9%	36.5%	36.5%	Tax rate	-	-	-	-
Net income - reported (GAAP)	(985)	(767)	(395)	Net income - reported (GAAP)	-	-	-	-
Diluted shares outstanding	219	220	220	Diluted shares outstanding	-	-	-	-
EPS - operating	(4.37)	(3.50)	(1.80)	EPS - operating	-	-	-	-
EPS - reported (GAAP)	(4.50)	(3.50)	(1.80)	EPS - reported (GAAP)	-	-	-	-
Balance Sheet and Cash Flow Data	FY12A	FY13E	FY14E	Ratio Analysis	FY12A	FY13E	FY14E	
Cash and cash equivalents	-	-	-	Sales growth	-	-	-	
Accounts receivable	-	-	-	Same store sales growth	-	-	-	
Current assets	-	-	-	EBITDA growth	-	-	-	
				EBIT growth	-	-	-	
PP&E	-	-	-					
Goodwill	-	-	-	EPS growth - operating	-	-	-	
Total assets	-	-	-	Gross margin	-	-	-	
				EBIT margin	-	-	-	
Short-term Debt	-	-	-	EBITDA margin	-	-	-	
Current liabilities	-	-	-					
Long-term Debt	-	-	-	Inventory growth	-	-	-	
Total liabilities	-	-	-					
Shareholders' equity	-	-	-	Debt / EBITDA	-	-	-	
D&A	-	-	-					
Change in working capital	-	-	-	Enterprise value / Revenues	-	-	-	
Cash flow from operations	-	-	-	Enterprise value / EBITDA	-	-	-	
Capex	-	-	-	P / E	NM	NM	NM	
Free cash flow	-	-	-					
Free cash flow / share	-	-	-					
Dividends	-	-	-					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Jan

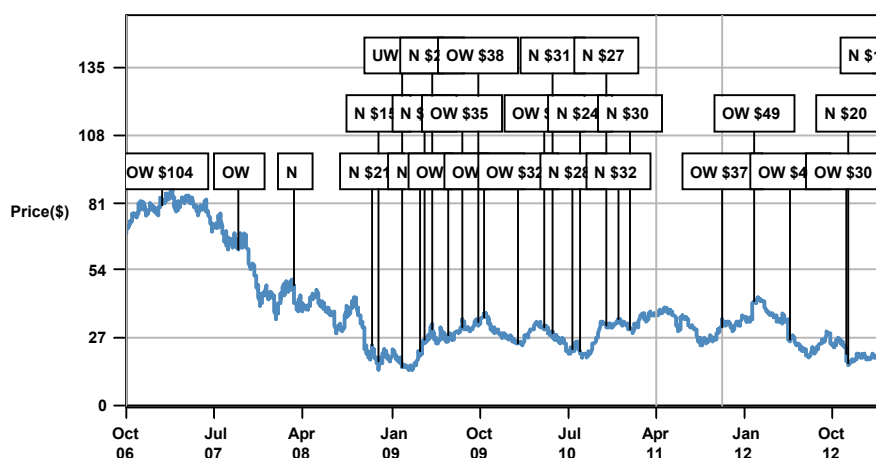
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J.C. Penney Co., Inc. (JCP, JCP US) Price Chart



Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Break in coverage Sep 13, 2007 - Mar 06, 2008.

Date	Rating	Share Price (\$)	Price Target (\$)
18-Jan-07	OW	79.61	104.00
13-Sep-07	OW	62.71	--
06-Mar-08	N	48.11	--
31-Oct-08	N	23.92	21.00
17-Nov-08	N	17.27	15.00
05-Feb-09	UW	15.07	10.00
27-Mar-09	N	21.49	19.00
13-Apr-09	N	26.52	23.00
08-May-09	N	30.51	28.00
25-Jun-09	OW	28.20	33.00
07-Aug-09	OW	31.40	35.00
23-Sep-09	OW	33.23	38.00
13-Oct-09	OW	35.54	39.00
26-Jan-10	OW	25.16	32.00
15-Apr-10	OW	31.40	33.00
11-May-10	N	29.07	31.00
12-Jul-10	N	22.56	28.00
09-Aug-10	N	21.53	24.00
27-Oct-10	N	32.26	27.00
06-Dec-10	N	34.42	32.00

12-Jan-11	N	30.49	30.00
20-Oct-11	OW	31.46	37.00
27-Jan-12	OW	41.42	49.00
16-May-12	OW	26.75	40.00
09-Nov-12	OW	20.64	30.00
14-Nov-12	N	16.89	20.00
20-Feb-13	N	20.19	18.00

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IB clients*	71%	62%	51%

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