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# EDITED TRANSCRIPT

## JCP - Q2 2017 J C Penney Company Inc Earnings Call

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**OVERVIEW:**

Co. reported 2Q17 YoverY total net sales growth of 1.5%. Expects 2017 adjusted EPS to be positive $0.40-0.65.



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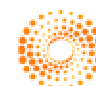

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## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the JCPenney second-quarter 2017 earnings conference call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Mr. Trent Kruse. Sir, you may begin.

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**Trent Kruse** *- J. C. Penney Company, Inc. - Manager, IR*

Thank you, Kaylee, and good morning, everyone. As a reminder, the presentation this morning includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which reflects the Company's current view of future events and financial performance.

The words expect, plan, anticipate, believe, and similar expressions identify forward-looking statements. Any such forward-looking statements are subject to risks and uncertainties and the Company's future results of operations could differ materially from historical results or current expectations. For more details on these risks, please refer to the Company's Form 10-Q and other SEC filings.

Please note that no portion of this presentation may be rebroadcast in any form without the prior written consent of JCPenney. For those listening after August 11, 2017, please note that this presentation will not be updated and it is possible that the information discussed will no longer be current.

Also, supplemental reference slides are available on our investor relations website. While management will not be speaking directly to the slides, these slides are meant to facilitate your review of the Company's results and to be used as a reference document following the call.

Today you will hear from Marvin Ellison, Chairman and CEO of JCPenney, as well as Jeff Davis our CFO, who will provide a few brief remarks about his first couple weeks at JCPenney. I will then rejoin the call to provide our Q2 financial overview and outlook. Following our prepared remarks, we look forward to taking your questions.



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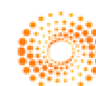

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With that, I will now turn the call over to our Chairman and CEO, Marvin Ellison.

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

Thank you, Trent. Good morning, everyone. While we are pleased with our Q2 performance, and let me highlight a couple of key wins from the quarter. First, we are pleased we delivered sequential comp sales improvement of 220 basis points from Q1 to Q2, and the total sales growth, including our closing stores, was a plus 1.5%.

We managed inventory very effectively, delivering a reduction of 6.8% versus last year. We are also very encouraged that our new apparel initiatives led to sequential comp improving in all apparel categories in Q2.

Omnichannel was also a big win for us in the second quarter. We rolled out free ship to store and online fulfillment from all stores, which contributed to significant growth in the second quarter. We are pleased with our ongoing efforts to reduce corporate overhead, with over 80 basis points improvement in SG&A. Finally, we increased free cash flow by over $230 million versus last year, which is a significant accomplishment for us.

Our comp improvement in Q2 is even more encouraging when you consider the results on a two-year basis, where we delivered a positive two-year stack of plus 0.9%. And as we look at the monthly breakdown for Q2, we delivered positive comps in May, low-single-digit negative comps in June, and approximately flat comps in July. And July's comp is significant when you consider that we are comping against a nearly plus 4% comp from July of 2016.

And our sales trend for July has carried into our early back-to-school selling season. And we are very pleased with our start to this critically important selling period. Our focus on outfitting kids of all sizes and styles has resonated well with our customers, and we see continued improvement in apparel, which will be key to our back-to-school success.

Now, getting back to the second quarter and our total net sales for the quarter was a plus 1.5%. And it was driven by the sequential improvement in comp sales and the liquidation event in our closing stores. These liquidation sales had a short-term cannibalization impact on the go-forward stores of approximately 20 basis points, meaning that the true underlying comp trend for the second quarter was down approximately 1.1%.

Now let's discuss margin. While we saw selling margin improvement of approximately 140 basis points in our go-forward stores, the effect from closing 127 stores had a greater impact on margin and EPS for the Company than we anticipated.

During the quarter, we closed and liquidated inventory in 127 of the 138 stores that were scheduled to close this year. The liquidation of inventory in these stores had a negative impact on margins of approximately 120 basis points. And this was much greater margin dilution than we anticipated.

While 120 basis points of margin is significant, it's isolated to Q2 and we see this as a one-time event. We have never liquidated this many stores at one time, so it was very difficult for us to forecast the margin impact in advance.

Having said that, we are reaffirming our EPS guidance for the first year and see Q2 as a unique quarter based on the large number of liquidated stores. Closing 138 stores was a very difficult decision, but we feel it was the right thing to do for our business. This decision will allow us to improve working capital, generate more cash flow, and invest capital in our more productive locations.

And although it is early, thus far we have experienced no negative impact to our dotcom sales or traffic in the ZIP Codes where we closed stores. This reinforces that the omnichannel strategy is working and we'll continue to focus on serving customers the way they desire to shop.

Before I discuss more details on the quarter, I want to turn the call over to our newly appointed Chief Financial Officer, Jeff Davis, for some brief remarks. Jeff?

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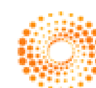

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**Jeff Davis** - *J. C. Penney Company, Inc. - CFO and EVP*

Thank you, Marvin, and good morning, everyone. It's a pleasure to join you on the call this morning. I'm excited to be a part of this incredible team. Having been here for just a few short weeks, it's very apparent that the entire organization has a heightened level of dedication and commitment to differentiate JCPenney from our traditional competitors.

In the coming weeks, I will continue my focus on identifying and supporting earnings growth opportunities, optimizing pricing, exercising SG&A discipline, increasing free cash flow, and further strengthening our balance sheet. In addition, I will be very focused on enhancing our planning and forecasting capabilities, with particular attention on improving the predictive analytics of our business to provide a clearer picture of current trends.

Having said that, the Company has done an outstanding job of improving its financial position over the last few years and returning the organization to profitability. I have full confidence that our strategic initiatives will continue to improve the financial strength and sustainability of the business and differentiate JCPenney as an omnichannel retailer. I will look forward to working with each of you in the coming weeks and months.

And with that, I will now turn it back over to Marvin.

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

Thank you, Jeff, and we are excited to have someone with your incredible background to join the JCPenney team. Now let's discuss what drove our improved sales performance in the second quarter.

As you know, it's critical for us to improve our core business apart from our growth initiatives. And I'm pleased to report that nearly all categories of our business saw improved sales from Q1 to Q2. Our growth initiatives of home and beauty, which consist of fine jewelry, salon, and Sephora, delivered positive sales in the quarter. We are also pleased we were able to deliver positive comps in shoes and handbags for the second quarter.

Although we experienced sequential comp improvement in all of our apparel performance, specifically in kids, total apparel still underperformed the Company's comp in the second quarter. As we discussed on our last call, kids was our toughest business in Q1.

And in the second quarter, we took learnings that drove improvements in our women's apparel business to enhance our performance in kids, including meaningful assortment changes, particularly in special size categories of girls plus and boys husky. And these changes drove over a 700-basis-point comp improvement in kids from Q1 to Q2.

In fact, I'm pleased to report that our continued focus on the special size business allowed us to deliver a 700-basis-point trend improvement in our total special size businesses across women's, kids, and men. We will intensify our commitment to being a destination for special size apparel for all customers.

In addition to our core business, let me take a moment to provide you with some added color on our growth initiatives in home and beauty, which delivered quarter-over-quarter strong performance and positive sales. So let's start with appliances.

Following the rollout of 100 new appliance showrooms in May and the success of our Memorial Day and Independence Day events, we saw an almost 300 basis points of positive benefit this quarter from appliances.

In addition, our focus on beauty is continuing to resonate with our customers and we are extremely pleased with our ongoing partnership with Sephora. And during the quarter, we opened a total of 32 new Sephora locations and we also recently completed 31 Sephora expansions, allowing us to deliver an enhanced product offering and experience in most of our productive Sephora locations in the Company.

Our salons also had an outstanding quarter, with our continued investment in rebranding existing salons to Salon by InStyle. We feel confident that we will continue to drive positive results in the back half of 2017 and beyond.



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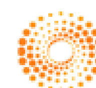

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And the before-mentioned omnichannel results were excellent this quarter and drove incremental upside relative to the first quarter and versus last year. We completed the expansion of our ship-from-store fulfillment strategy, expanding it from 250 stores to 100% of our store network during the second quarter. This means that all JCPenney stores now have the ability to fulfill online ship-from-store orders, and this also significantly expands the fulfillment capacity of our Company while helping us reduce the last-mile delivery cost.

Not only did this initiative enhance our fulfillment capabilities, it also allowed us to expose over $1 billion of additional inventory to our customers without one dollar of investment in new inventory. Our process on omnichannel continues to be significant and I will share more on the call later on this initiative.

With that, let me turn the call over to Trent to provide more details on our financial results, balance sheet, and capital market activities for the quarter. Trent?

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**Trent Kruse** - *J. C. Penney Company, Inc. - Manager, IR*

Thank you, Marvin, and good morning, everyone. We are pleased with our improved sales trends in the second quarter. We achieved sequential comp sales improvement in nearly all of our categories compared to the first quarter. These improvements were driven not only by our growth initiatives, but also within our core businesses, particularly apparel.

In a few moments, I will cover our second-quarter results and discuss the financial opportunities we have for the back half of 2017. I will walk you through what we achieved in the debt capital markets this quarter and then close out with a review of our second-quarter balance sheet, cash flow, and our financial guidance.

But before we begin, I want to update you on a presentation change we made this quarter to our financial statements. You may have noticed that we now only disclose our cost of goods sold results for all periods presented and are no longer reporting gross margin on a separate line item.

We made this change in Q2 to follow the SEC's preferred presentation methods and disclosures. To clarify: no changes were made to the actual calculation of gross margin. You can arrive at our standard gross margin by simply taking the inverse number of cost of goods sold.

Let's now turn to our second-quarter results. Total net sales for the quarter increased 1.5% versus last year. Comparable store sales declined 1.3% for the quarter. We are pleased with this sequential sales acceleration and even more so when we consider we faced our most difficult top-line comparison of the year this quarter.

This led to a comp increase of 0.9% on a 2-year stack basis. And in fact, July was our best month on a 2-year stack basis, with an almost 4% increase, which bodes well as we move towards easier comps in the back half.

As Marvin stated earlier, our closing store liquidation efforts had a short-term cannibalization impact to comp sales in our go-forward stores of approximately 20 basis points this quarter, which gives us an underlying comp trend for the quarter of down approximately 1.1%. The 280-basis-point spread between total sales and comp sales is related to the liquidation of inventory surrounding the closing stores during the second quarter.

For comp stores, units per transaction and average unit retail were up versus last year's second quarter, while transaction counts were down. Geographically, the Southwest and Southeast were the best-performing regions of the country and the Northeast was our worst-performing region.

Margin for the second quarter was 35.1% of sales, a decline of 200 basis points compared to the same period last year. While we expected margin to be down on a year-over-year basis due to the liquidation of inventory and our closing stores, the decline in our margin rate from these efforts was greater than we originally anticipated.

The liquidation event pressured margin by approximately 120 basis points in the quarter. And while it was a much greater impact than our original expectations, it was isolated to Q2 and we see this as a one-time event.





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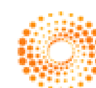

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Although these liquidation efforts negatively impacted margin in the short run, it helped reduce our inventory to put us in a better position for the back half. This is clear when you see our inventory results of down 6.8%. To put this into perspective, our comp store inventory declined approximately 3.7% in the quarter.

In addition to closing stores, we experienced increased margin pressure relative to our expectations from shrink and the continued growth in both our online and major appliance businesses. Having said that, merchandise margins in our go-forward stores were up over 140 basis points year over year as we continue to see benefits from our ongoing margin initiatives.

Looking ahead to margin in the back half of 2017, we expect our ongoing margin initiatives to continue having a positive impact on selling margins as we realize greater benefits in areas such as pricing analytics, modernizing our replenishment process and systems, and improving the profitability of our private brands through design, sourcing, and speed-to-market initiatives.

Having said that, and given the impact from store closures on our gross margin rate in the second quarter, we now expect our full-year margin rate to be in the guided range of down 30 basis points to 50 basis points.

Moving now to expenses. SG&A expenses for the quarter were $842 million or 28.4% of sales, leveraging 80 basis points compared to the same period last year. The savings were primarily driven by private-label credit card income, store controllable costs, and corporate overhead.

We recorded approximately $23 million in restructuring charges, largely associated with the closing stores in the second quarter. As we announced with the commencement of our store closing program earlier this year, we expect to record an estimated $50 million in restructuring charges, primarily associated with the present value of remaining lease obligations in the third quarter.

While our margin performance for the quarter was below our expectations, much of the miss was related to the closing stores, which is now behind us. And we continue to effectively manage the business by delivering significantly improved free cash flow and maintaining our focus on expense management.

Let's now turn to our liquidity position and capital structure. During the quarter, we continued to focus on strengthening our balance sheet through the significant reduction of outstanding debt. In May, we completed the previously announced $300 million tender on portions of both our 2018 and 2019 outstanding bonds.

We utilized the proceeds received from the sale of the home office and cash on hand to fund the tender offer. The retirement of these bonds is expected to contribute annualized interest expense saving of approximately $23 million.

By reducing the aggregate principal amount outstanding on the 2018 and 2019 maturities to levels below $200 million each, we now have a very manageable debt maturities over the near term.

With the successful completion of this tender offer, we have now reduced our outstanding debt levels by well over $500 million since the start of this year. These combined actions resulted in $40 million of annual interest expense savings.

We expect our 2017 net debt leverage ratio to be approximately 3 times by the end of the year. This is down from 3.7 times at the end of 2016 and 5.4 times at the end of 2015.

Let's move now to cash and inventory. As I just discussed, we used available cash on hand in May to tender $300 million of outstanding bonds. We ended the second quarter with $314 million of cash and cash equivalents and no outstanding borrowings under our ABL. As such, our liquidity position at the end of the quarter was approximately $2.3 billion. Capital expenditures, net of landlord allowance in the quarter, were $103 million.

During the second quarter, we generated positive free cash flow of $303 million, an improvement of $234 million versus the same period last year. We are pleased to see such strong cash flow generation and recognize we have continued opportunity to rightsize our inventory across the enterprise.



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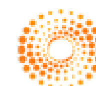

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The focus here will not only generate improved cash flow, but allow us to enhance sellthroughs and inventory turns, which should lead to reduced markdowns and stronger margin performance moving forward.

Inventory at the end of the second quarter was $2.777 billion, down 6.8% from last year's second quarter and down 3.7% on a comp store basis. We are prudently managing our inventory levels and are pleased with the progress we have made to date in 2017. Our teams remain committed to reducing inventory levels where appropriate throughout the remainder of this year.

Merchandise accounts payable was $950 million, down $144 million from the end of second quarter last year. And the decline was primarily due to reduced receipts in the second quarter as we continued to focus on improving our overall inventory position.

Now moving to guidance. We have updated our cost of goods sold guidance and are reaffirming our remaining guidance for 2017. Before I provide the updated metrics, just a reminder that 2017 is a 53-week year, the impact of which has been incorporated into our guidance.

For fiscal 2017, comparable store sales are expected to be down 1% to up 1%. Cost of goods sold is now expected to be in a range of up 30 basis points to 50 basis points versus last year. SG&A dollars are expected to be down 1% to 2% versus last year.

Adjusted earnings per share is expected to be in the range of positive $0.40 to $0.65. And free cash flow guidance remains at a positive $300 million to $400 million.

In closing, we are pleased with the sales acceleration and particularly our two-year stack performance as we exited the quarter in July. And we continue to manage the business well through exercising SG&A discipline, controlling inventory levels, generating free cash flow, and strengthening our balance sheet.

With that, I will now turn the call back over to Marvin.

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**Marvin Ellison** *- J. C. Penney Company, Inc. - Chairman and CEO*

Thanks, Trent. And while we remain focused on our strategic framework of private brands, omnichannel, and increasing revenue per customer, I'd like to discuss the key growth initiatives that give us confidence in our ability to continue delivering improved sales, profitability, and delivering our earnings expectations for the back half of 2017.

First, our beauty categories continue to deliver positive sales results. And one of our key components of beauty is our best-in-class partnership with Sephora. And as a reminder, we now operate over 600 Sephora inside JCPenney shops and we opened a total of 70 locations in 2017.

And in the third quarter, 38 of these new locations will open. This will allow us to end the year with nearly 650 locations. And at that time, we will have Sephora shops in approximately 75% of our stores.

We are also excited to announce Fenty Beauty by Rihanna will be launching this quarter and will be exclusive to both Sephora and Sephora inside JCPenney. We believe this new launch will drive incremental sales and foot traffic to our Sephora inside JCPenney shops in the second half of the year.

Another component of our beauty strategy is salon, and JCPenney's salon business remains a key component of our beauty strategy. And we see continued benefits in rebranding to Salon by InStyle. In addition to rebranding, we are focused on the enhancing of our digital and mobile scheduling platform as well as hiring talented stylists.

And as a reminder, our salon customers shop the stores twice as often per year as our non-salon customers. So we see the salon rebranding as a tremendous customer acquisition strategy.



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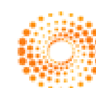

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And our fine jewelry business had another strong quarter of delivering positive comps. We are the only retailer that can offer the combination of Sephora, salon, and fine jewelry under the same roof. And at JCPenney, we are creating a unique beauty experience that cannot be replicated online and one that brings theater and excitement to our physical stores.

Second, our home refresh initiatives continue to provide strong results. We delivered positive comps in our home division for the second quarter. Appliance sales, both in-store and online, continue to drive significant comp sales growth and improved productivity in our home store.

As we continue to drive market share gains in this category, we are excited to announce we've signed a new partnership with Electrolux home appliances. And through Electrolux, we will be carrying a complete line of kitchen appliances from Frigidaire later this quarter. Adding Frigidaire to our assortment gives us the ability to drive business-to-business sales with one of the industry's best opening price point brands.

We are also extremely excited about the expanded footprint of mattress to our assortment. In the second quarter, mattresses delivered significant comp growth and we are well on the way with the rollout of over 300 in-store mattress showrooms.

Our assortment will include perception-shifting national brands such as Tempur-Pedic, Sealy, Serta, Stearns and Foster, Simmons, and Beautyrest. The store expansion rollout will give us a total of just over 500 stores with mattress showrooms by Labor Day.

And third, we are committed to becoming a world-class omnichannel retailer. We continue to significantly increase online SKUs and we have plans for continued SKU expansion throughout 2017.

We recently announced that all online orders would ship free to our stores with no minimum threshold required. We are confident that this new strategy will drive incremental customer footsteps to our stores.

We are well on our way to creating a best-in-class omnichannel business here at JCPenney. Our buy online pickup in store same-day initiative remains critical to our omnichannel strategy.

And today, approximately 80% of these stores' existing inventory is eligible for free same-day pickup. This is a tremendous milestone, given that we introduced this feature just one year ago in July with a limited number of SKUs eligible when we launched.

As we now drive more online customers into the store, we will continue to minimize our last-mile delivery cost and drive meaningful traffic to our stores. In fact, in-store order pickup drives over 600,000 customer visits to our stores each week.

There is very little argument that the future of retailing is omnichannel. In other words, with last-mile fulfillment and customer acquisition costs increasing and the customers demanding speed and value, the retailer who can most effectively combine physical stores, e-commerce, and simplicity will be the winner.

Fourth, we are finding new categories and opportunities to grow our business. The toy industry is a $20 billion industry today and continues to grow. And after a great customer response to testing toys last holiday season, we confidently made the decision to open toy shops in all go-forward store locations in time for back-to-school. These new toy shops will drive increased traffic and sales in store and online as we continue to focus on increasing revenue per customer.

Lastly, we continue to improve and strategically adjust our apparel categories with an emphasis on fixing our women's apparel business. In the past, JCPenney has been overassorted in traditional women's clothing and underassorted in casual and contemporary women's clothing.

In the second quarter, we took aggressive steps to liquidate some of the less-desirable apparel inventory to make room for the expansion of more casual and contemporary women's apparel being launched for back-to-school and the fall season.



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And the first step in converting women's apparel to a more casual environment was to increase our penetration in activewear. We are accomplishing this by expanding our relationship with Nike and adidas while providing our customers a great opening price point option with our activewear private brand Xersion.

We have a great partnership with two of the leading activewear brands in the world. And our recent results reflect that our customers are positively responding to our expanded assortment of activewear.

The next step is to offer our female customers a trend-right contemporary offering that fits her busy lifestyle. We are addressing this need with our recently announced exclusive partnership with legendary footwear designer Libby Edelman.

Libby will bring an exclusive collection of apparel, contemporary shoes, handbags, and accessories to JCPenney. Libby's product will be available in 500 stores and at jcpenney.com.

And in an effort to continue the expansion of our contemporary assortment, we recently announced the launch of the first-ever Project Runway brand inspired by the Emmy-nominated show and its talented group of design contestants. The brand is now available in over 500 JCPenney stores and at jcpenney.com, and we have a full assortment planned for September 8. And JCPenney will be the exclusive retail partner for Project Runway.

Finally, we are leveraging our private brands and design and sourcing infrastructure to introduce our customers to our City Streets private brand. City Streets will offer our customers an everyday low price that is contemporary, trend-right, and at a low price.

Our early results with our new City Streets brand have been exceptional. And in addition, during the fall season, we will enjoy a 40% improvement in design to delivery cycle time in many of our private brands. And this will allow us to maintain trend relevance while reducing inventory.

So in closing, we are very focused on two critical factors. First: to operate the business for growth; and second: to deliver earnings profitability. And as a company, we will fine-tune our focus to ensure consistent sales growth, debt reduction, cash flow generation, and EPS growth.

While circumstances like closing stores often dictate a change in how we approach margin plans and expense management on a short-term basis, we are laser-focused and confident in our ability to deliver on our sales and earning guidance for 2017 and beyond.

With that, Kaylee, we will open the line for questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Lorraine Hutchinson, Bank of America.

**Lorraine Hutchinson** - *BofA Merrill Lynch - Analyst*

Thanks, good morning. The second quarter comp, even if you take out the cannibalization from the closed stores, missed your full-year guidance range. And now as we move to the back half, you are coming up against some pretty significant comps from the appliance launch.

I guess I was just curious. Do you need apparel comps to go positive or traffic to go positive to hit your full-year plan? And what gives you confidence that you can accelerate that comp even up against some tougher comparisons?



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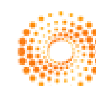

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

Loraine, as we look at the appliance launch, starting with that, our original pilot stores comped positive in the second quarter. And that's without the new introduction of a new brand in Electrolux and Frigidaire.

So we are very excited about appliances and we think that we are continuing to take market share. And we see that business as a growth business and we are not concerned with the overlap.

In addition to that, we have learned a lot from a marketing perspective. And we are very pleased that our new Chief Marketing Officer has a background in the appliance space. And she is bringing some insight to us that will help us get the message to our customers on a more sustained and effective basis.

But as we think about the second half of the year, I want to remind you that our easiest comparisons are in the second half, the third and fourth quarter. Our most difficult comparison was in the second quarter. We comped against roughly a plus 2.2% last year. And as I mentioned, roughly a 4% comp in July.

And we mentioned in our earnings release and in the prepared comments that the very important back-to-school season is off to a good start. And that's important for us to make the back half.

In addition to that, remember: we are going to open 38 new Sephora locations this quarter. We are expanding 300 mattress showrooms and we are going to have 500-plus stores that will hit Labor Day, like the number one sales event for mattresses. And we are going to be ready for that business.

Not to mention new categories like toys, the expansion of dotcom, and really the great momentum we are starting to see in the plus size business. So as we look at our guidance for the back half, we are very confident that we can hit our guidance. The growth initiatives and the implement in the business give us that confidence.

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**Lorraine Hutchinson** - *BofA Merrill Lynch - Analyst*

So do you need apparel to comp positively in the back half? Or you --

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

We do not. We do not. It's not planned to comp positive. We are making the improvements we discussed in the prepared comments, but there is no expectation in our financial plan that we are dependent upon a positive comp in apparel for us to hit our guidance for the back half of the year.

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**Lorraine Hutchinson** - *BofA Merrill Lynch - Analyst*

And then what happened with the liquidation sales? It seems like you left the stores open a little longer; things were going better than you thought. You had some positive comments on the announcement, the CFO announcement. And then for such a big miss, I guess I'm curious. What changed during that time period in July?

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

Well, to be very transparent, we have never liquidated 127 stores at one time. And we made the decision that we wanted to exit these locations by July 31. It was my decision not to take the closing process into back-to-school and into the holiday season. So we had a definitive date that we wanted to exit those stores.



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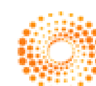

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Quite candidly, it was very difficult to forecast 127 stores and the financial impact when we had no history to really lean on. Having said that, we look back on that and we are still pleased with what we had to do. And we saw an acceleration in our liquidation cadence the last three weeks of the process, which gave us a challenge with our forecasting process.

Just let me remind you: this is a one-time event for the second quarter. And I made the decision not to run the business for the quarter, but for the year. We have inventory down almost 7% versus last year. We generated aggressive free cash flow of plus $200 million.

So we feel like we walked away from the liquidation event a stronger company with a better balance sheet and with a more stable foundation for the second half of the year. It simply came down to having very little history to forecast the impact. And from that, we are still maintaining and reaffirming our EPS guidance for the back half of the year.

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**Lorraine Hutchinson** - *BofA Merrill Lynch - Analyst*

Thank you.

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**Operator**

Paul Trussell, Deutsche Bank.

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**Paul Trussell** - *Deutsche Bank - Analyst*

Good morning, Marvin and Trent, and welcome, Jeff. So with the gross margin -- the gross margin impact from closing stores was obviously a one-time event, but it did hurt your overall plan for the year.

With comp and SG&A guidance seemingly the remaining the same, I just want to make sure that there isn't anything else that we are missing that led you to maintain the same EPS view.

And also, as we think about the factors impacting gross margin going forward, can you give us some quantification to appliances, dotcom, and price investment. And how that is impacting gross margins, especially in the second half. And then how you can offset these items. Thank you.

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

I will take the first part and then I will hand it to Trent to provide a little more context and color. So as we look at gross margin for the year, again, we are just trying to be very transparent and not to overreach and try to make up all of the dilution in the second half of the year.

So we made the decision that because this dilution of 120 basis points was greater than what we anticipated, we would just bring the guidance down for the back half of the year. So not to put top line and other initiatives at risk. As I said in the previous question from Lorraine, this really came down to just a lack of history in understanding the impact of 120 stores being liquidated.

Now, having said that, we feel good about the entire closing store process. And the store operations team, really led by Joe McFarland and Steve McKalvey and a really effective cross-function team, did an exceptional job of getting this done as flawlessly from an operations standpoint as we could hope.

But as we look at the back half of the year and we look at our initiatives and we look at some of the gross margin improvement strategies we have in place, we feel good about our ability to hit our earnings and to maintain our other key financial guidance. Trent will talk about that in a little more detail.





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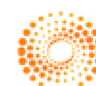

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But the last point I will make is just a reminder: in go-forward stores, selling margins were up roughly 140 basis points. So that sends a signal that we don't have a gross margin problem in the Company. We had 127 stores liquidate, which drove margin down and we didn't forecast it as well because we had very limited history.

Now I will hand over to Trent to provide a little bit more color.

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**Trent Kruse** - *J. C. Penney Company, Inc. - Manager, IR*

Thanks, Marvin. Yes, in terms of the full-year guidance at the bottom line, there is no additions below the line. We don't have any expectations for added asset sales or anything like that.

There is a transaction expected in the fourth quarter, as we discussed earlier in the year. But nothing incremental coming out to support the bottom-line guidance.

I think as far as appliances and dotcom go, look, we knew and know there is pressure in those businesses. But our dotcom business was very strong in the second quarter; accelerated above our expectations, but drove a little bit of pressure.

But frankly, the margin performance in Q2 was really a function of the liquidation and shrinkage coming in above our expectations. So as we work to improve on the shrink side, we've certainly staffed in that area. We are adding process. Feel we can certainly get that under control, and that's absolutely within our control.

To Marvin's point, when you look at what we are able to do in our go-forward business with margin enhancements, a lot of that is what we are seeing in pricing, what we are seeing in our coupon initiatives, and what we are starting to see from our speed-to-market initiatives.

Much of the product landing now in the back half of the year is on our enhanced calendar, which will allow us to flow goods more effectively, closer into need, and avoid markdowns at the end of the season.

And obviously with inventory being down 6.8% at the end of this quarter with more work to do, we feel confident that those benefits will also start to show up in the back half of the year in terms of margin performance relative to inventory and where we are with the goods.

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**Paul Trussell** - *Deutsche Bank - Analyst*

That's helpful color. Just a quick follow-up. The home refresh is obviously an ongoing initiative and you continue to roll out to new stores the appliances, furniture, mattresses. And you've outlined some new brands joining.

Just curious, by year end, how should we think about the percent of the store and the percent of sales that's coming from these larger -- these big-ticket items. And just interested in how you continue to balance out the store presentation between softlines and beauty versus hardgoods.

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**Trent Kruse** - *J. C. Penney Company, Inc. - Manager, IR*

Yes, Paul, it's Trent. I will take that. I think when you look at home in our store, we are occupying nearly 20% of the floor space in home and generating roughly 13%, 14% of sales. So we have clear opportunity to enhance the productivity in our home store. These big-ticket areas are allowing us and helping us to do that.

Appliances, mattresses, furniture. These are businesses that our customers are coming to the store, they want to interact with these products in a physical location, and it's helping us drive enhanced productivity.



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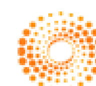

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So when you think about it in those terms, the presentation space in the store is not really changing from a home perspective. We are just presenting more of what she is looking for and streamlining the assortment in some of the other areas that haven't lived up to our productivity expectations.

So clearly, I think when you look at it from those terms, the rest of the store -- 80% or a little more -- is targeted in the other categories outside of home. Clearly as we continue to grow Sephora, what we are seeing in the beauty area is taking up a little bit more of our store, which is great. That's a high productivity area and a great business for us that allows us to not only drive increased productivity, but welcome new customers into our store, and in particular younger customers into our store.

So I think the balance is right. We are looking to give the customer what she wants and allow her to shop for it the way she wants to shop for it. I think we have done a nice job of that and the initiative performance shows that.

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**Paul Trussell** - *Deutsche Bank - Analyst*

Thanks a lot. Best of luck.

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**Operator**

Mark Altschwager, Robert W. Baird.

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**Mark Altschwager** - *Robert W. Baird & Company, Inc. - Analyst*

Great, thanks for taking the question. Wanted to follow-up on gross margin. Just so I have the numbers right: selling margin up 140 basis points. I think you said liquidations were a 120-basis-point headwind, so that would still get you a net positive. So I guess the shrink must've been a pretty significant swing factor.

Just as you hindsight the results there, any further color on what drove such the significant deviation versus expectations in the recent results? And to the extent that is fixable, how should we be thinking about the pace of improvement?

And I think you just mentioned that you are adding some staff to help on that. So how should we be thinking about that within the context of the SG&A guidance range you provided? Thanks.

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**Trent Kruse** - *J. C. Penney Company, Inc. - Manager, IR*

Yes, sure, Mark. It's Trent. Thanks for the question. The 140-basis-point margin -- selling margin improvement, that's in the comps stores. So you can't net those two numbers together necessarily.

Clearly, we did see shrink come in above our expectations. I think we have opportunity in that area. We are adding some staffing, but that's still within our SG&A guidance. It's not a overly meaningful number, frankly, and we think that continue to have opportunity in SG&A. But again, the 140 basis points is in the comp stores.

I think what's important, too, on margin is the channel mix. I mean, look, we are seeing enhanced omnichannel sales, which does drive some pressure. But as Marvin alluded to in his remarks, as we continue to do more in our store and drive more pickup in our store, that is having benefits and will have benefits as we move forward in terms of what margin rates we actually see on digital transactions.

So I think that's (technical difficulty). And the shrink team -- frankly, they've put a lot of processes in place. I think they certainly have their arms around where the issues lie. And we expect to be able to begin to make some real progress on that. And again, this is something that's in our control and we have put a very clear focus on it, as you can imagine, and we are going to go out and fix that.



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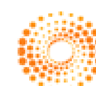

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

And Mark, the vast majority of my early retail career was focused specifically on this operational issue. And so as you look at the second half, our guidance reflects what we believe the shrink trend will be for the balance of 2017.

We have put process in place; we have put technology in place. And the process and technology in my estimation will reap more benefits than additional staffing. But they all play a role together.

But we will fix this. This is 100% within our control, and we are going to manage it and we will get the number down. And we think that we will have a tailwind relative to going up against these numbers next year.

**Mark Altschwager** - *Robert W. Baird & Company, Inc. - Analyst*

Thank you for that. Just a quick follow-up on Sephora. I think you noted positive in beauty. Is that still growing double digits, any color there? And what are you seeing from a promotional standpoint in the beauty category? Thank you.

**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

So from a beauty perspective, we look at it holistically with salon, Sephora, and our fine jewelry business. And we are just exceptionally pleased with what we are seeing in all those businesses.

We talked about the Fenty Beauty launch with Rihanna. Rihanna has one of the largest social media followings of any celebrity and she is already out talking about this new launch in Sephora. So we are excited about the foot traffic that that is going to bring.

In addition to the fact that the rebranding of the salon businesses and the technology enhancements is really driving increased productivity to that business. And as a reminder, when we can get this younger customer in Sephora and we can get her transitioned over to the salon business, I mean, it's a unique experience that we provide. And we are just excited about the possibilities.

And we talked about the continued growth of fine jewelry year over year. And we see the second half as another unique opportunity for us to bring great products and value to the customer. So overall, beauty is a growth area for us, as home, as plus size. And we see great upside for the second half of the year.

**Mark Altschwager** - *Robert W. Baird & Company, Inc. - Analyst*

I appreciate the color. Best of luck with back-to-school.

**Operator**

Erinn Murphy, Piper Jaffray.

**Erinn Murphy** - *Piper Jaffray & Co. - Analyst*

Thanks, good morning. I guess I had a first question on the month of August. Marvin, you talked about it being similar to July. Just to clarify, are you saying that comps are flat thus far? And then underpinning that, what are you seeing currently in terms of traffic versus ticket and conversion?



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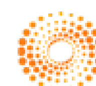

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And then as you think about the second half for your comp guidance, what are you implying for traffic underpinning that to get to the negative 1% to up 1% for the year? Thanks.

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

So, Erinn, I'll address the (technical difficulty) and I will let Trent get into the traffic and ticket. For the month of August and the early back-to-school, we are virtually on plan. And for us being on plan is strong performance in this really unique and challenging environment.

As you probably know, there were some tax-free shifts in certain states. And so from a comp perspective, it's almost impossible to look at the business through that lens this early. But relative to how we plan the business, we feel great about where we are. And we are right in the range that we hoped we would be going into some of these big tax-free events.

What's important about that is July was the most difficult year-over-year compare from a comp perspective that we had in the quarter. And as a reminder, July was plus 4% last year and we basically ended that month approximately flat. And so it's great for us to see that momentum carried into the month of August and back-to-school.

And on any given day, we would probably not spend any time talking about back-to-school because it is early. But relative to the choppiness in this environment and the unique nature of this retail sector that we are in, it is just a simple way for us to demonstrate competence in the business to show that in these early very important weeks of back-to-school, we are basically at our plan. And that's very important to us.

I will let Trent take some of the other parts of the question.

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**Trent Kruse** - *J. C. Penney Company, Inc. - Manager, IR*

Thanks, Marvin. I think in terms of traffic, that's what drove a lot of the increase from Q1 to Q2 was an improvement in overall traffic and transactions. We do not expect it to move to positive clearly for the back half of the year, as you might suspect. But again, our toughest -- not only the toughest comparison, but certainly the toughest traffic comparison was in the second quarter as well and we saw that tick up relative to Q1.

So our expectation is that the transaction value will drive much of the improvement along with what should be a steady increase in total traffic. But we are not expecting that to flip to positive. We know that it's a tough environment in terms of traffic.

But I think as Marvin has discussed very well, we have a lot of new initiatives continuing to come in. These things are working; they are resonating with our customer. So I think that's going to drive some improvement relative to what we've seen in the first half of the year from a traffic perspective.

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**Erinn Murphy** - *Piper Jaffray & Co. - Analyst*

Okay, that's helpful. And then I guess just bigger picture on your appliance initiative. I mean, Marvin, have there been any changes of how you are thinking about that strategy now that Costco is getting more into that category. You've had the Amazon Kenmore partnership announced about a month ago as well. Just curious if there is any changes of how you see that initiative in your business over the next year or two? Thanks.

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

It's a very good question; a very timely question. What's unique about JCPenney is that we have a customer that really operates in a household income of roughly $80,000 and below.





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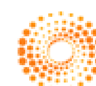

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So when you make an appliance purchase of a couple thousand dollars, you want to come into the store, physically touch it, see it, and you want to get some level of consultation from the associate. So although e-commerce is a great platform for us from the appliance perspective, it is tied to the physical store and the associates' product knowledge in the store.

So although we look at every competitive pressure point of brick-and-mortar and online, we don't see anything happening in the marketplace that gives us any pause. Because this is net new business for us.

And as we add a new brand like Electrolux or Frigidaire and we bring in an opening price point, it's only going to serve our customers who are looking for value. And give our team that's really focused on business-to-business sales led by Joe McFarland and his team the ability to go out and to take the industry-leading opening price point brand and do different types of transactions to a broader customer segment than just the residential customer.

So having said that, we feel great about the strategy, we feel great about adding a fourth brand in Frigidaire. And we have a great marketing cadence planned that we think will allow us to continue to take market share. And we are excited about the possibilities.

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**Erinn Murphy** - *Piper Jaffray & Co. - Analyst*

Thank you for that. Best of luck.

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**Operator**

Bob Drbul, Guggenheim Securities.

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**Bob Drbul** - *Guggenheim Securities LLC - Analyst*

Marvin, I was wondering if you could give us the women's comp this quarter. And you talked about clearance on women's merchandise this quarter. Did that have a significant impact on the results at all on the gross margin results?

I was wondering secondly if you could talk to the active business with -- you talked about Nike and adidas. But how that business is performing for you with some of the competitive changes that are going on in that space as well. Thank you.

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

Okay, Bob, thanks for the question. And Bob, our Chief Merchant John Tighe is here. So I will the first part and I will let John provide some additional color.

Relative to women's, we don't give comp out by individual division. But what we will say is that we continue to see improvement quarter over quarter and that's very important for us. As you know, women's apparel is a significant percent of our overall revenue and that business has been under significant pressure for the last year-plus.

And although we are excited about home initiatives and beauty, we also are laser-focused on fixing the women's apparel business. And although we are not going to give you the specific comp, we can tell you that the business improved.

And some of the liquidation decisions we made were strategic and they were planned because we wanted to free up the ability of the merchants to land product for back-to-school and the fall season that's more active and more contemporary.



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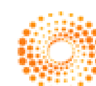

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We believe, as I said in my prepared comments, that one of the key reasons why this business has been under so much pressure at JCPenney is because we were slow to react to the changing trends in how women dress and what they are looking for.

So we are deemphasizing and reducing our presentation and penetration of more traditional clothing. And we are going to be more aggressive in going after more casual and contemporary. And that ties directly to activewear with our focus on adidas, Nike, and our Xersion brands.

So I am going to hand it over to John and he can provide some more color about the fall season and what we are planning in women's apparel. And how we see activewear as a continued to benefit for us as a Company. John?

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**John Tighe** - *J. C. Penney Company, Inc. - Chief Merchant and EVP*

Okay, good morning, Bob. This is John Tighe. Yes, we see the women's apparel improvement continuing as we move through fall. We have a really deep effort to launch more contemporary clothing.

In September, you will see four brands get emphasized and brought to the mall door. As Marvin mentioned, our new partnership with both Libby Edelman and Project Runway will both launch in September.

And then growing activewear continues to be a major opportunity for JCPenney. We saw double-digit growth in the spring season. We expect that to continue again through the back half, leveraging both our great partnership with the number one apparel brand of Nike, rolling out adidas to more doors, as well as maximizing value with our own Xersion brand.

And then the last part of growing the apparel business is really understanding the customer. We did a huge deep dive into who our customer is. We reorganized our whole women's apparel, both merchant design and product developing teams, to be aligned by the customer segments. And we are going to use our new speed initiative to bring faster fashion to the floor with great value.

So you will see a huge change in the floor as we move through September. And we expect that to continue this momentum that we have seen in apparel.

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**Bob Drbul** - *Guggenheim Securities LLC - Analyst*

Thank you very much.

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**Operator**

Dana Telsey, Telsey Advisory.

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**Dana Telsey** - *Telsey Advisory Group (TAG) - Analyst*

Good morning, everyone. Can you talk -- I know it's early days. Can you assess at all how much of the sales from the closed stores are you retaining in surrounding stores? And then promotional plans for the back half versus last year, how you are thinking about it? And just lastly, given the further reduction in debt, what interest expense are you now looking for for the year? Thank you.

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

So Dana, I will take the first two questions. I will let Trent take the last one. Regarding closed stores and retained sales, it is too early for us to tell. Obviously, we're paying very close attention.



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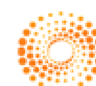

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And in my prepared comments, I did mention that in the ZIP Codes where we closed stores, we have seen no sales or traffic reduction in our dotcom business. That's significant. And we have great data analytics put in by Mike Amend and his team that really gives us really real-time visibility. So that's the first sign that maybe our retaining the customer strategy is working and the omnichannel will be critically important to make that work.

Regarding the promotional plan for the second half of the year, look, we anticipate that the marketplace will remain very promotional. And we anticipate that there may be some accelerated promotional activity in the second half of the year versus what we have traditionally seen.

But we are prepared for that. It is built into our earnings guidance. And even with that, we are very confident that we will meet our earnings guidance for the second half of the year in the face of what we think will be a slightly more promotional environment.

And I will hand it over to Trent to let him answer the last part of your question.

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**Trent Kruse** - *J. C. Penney Company, Inc. - Manager, IR*

Hey, Dana. In terms of interest expense, we should be right around $330 million total for the year following the actions that we've taken. And I think, as you can imagine, we continue to look at the capital structure and focus on deleveraging the balance sheet and finding debt takeout opportunities. But based on what we've done this year, it would be right around $330 million for the full year.

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**Dana Telsey** - *Telsey Advisory Group (TAG) - Analyst*

Thank you.

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**Operator**

Kimberly Greenberger, Morgan Stanley.

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**Kimberly Greenberger** - *Morgan Stanley - Analyst*

Thank you so much. Good morning. Marvin, I wondered if you cared to comment on e-commerce. I didn't hear -- and forgive me if I didn't get it correct -- but is it still growing double digits? Teens, 20%s? Any color you could give around that would be very helpful.

Secondarily, Trent, we are trying to figure out how to think about SG&A going into the third quarter, given the store closures. I am not sure if you have any additional guidance you might be able to offer there.

And then lastly on inventory, is it -- in order to get to the 3.7% decline in comp store inventory that you cited, can we simply take the balance sheet inventory and divide it by the number of stores? Or is there a differential and does it exclude certain pockets of inventory? Any color there would be helpful.

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**Marvin Ellison** - *J. C. Penney Company, Inc. - Chairman and CEO*

I will take the e-commerce question and allow Trent to address the SG&A and inventory questions. On e-commerce, we are exceptionally pleased with the -- in the second quarter and the spring season. It is up double digits and we see that growth sustaining.

We are pleased with the acceleration of SKU expansion online. We are exceptionally pleased with the adoption and the execution of the stores from the fulfillment within store. And I mentioned in my prepared comments that 100% of our stores now ship and fulfill e-commerce orders.



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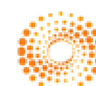

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And our BOPUS strategy, although it is a fundamental staple of e-commerce for all retail, for us to have transitioned as aggressively as we have in one year has been nothing short of amazing. So we are pleased with it. The growth is incredibly strong and we see that sustaining in the second half.

And I want to give Mike Amend our e-commerce leader, Mike Robbins in the supply chain, and Joe McFarland in our stores enormous credit for just great alignment and working together with the merchants. And John Tighe's team to make this truly our growth initiative for the future.

And I will hand it over to Trent to answer your last two questions.

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**Trent Kruse** - *J. C. Penney Company, Inc. - Manager, IR*

Thanks, Marvin. In terms of SG&A for the third quarter, certainly our expectations are down. I think somewhere in the $25-million-plus range is probably a reasonable way to look at it. It should be meaningful reduction, again, not only from closing stores, but certainly from a continued focus on that line item and continued opportunity there.

In terms of the comp store inventory, that is related to the 875 stores. Now, you can't simply take the inventory, I would say, divided by the stores. Our stores are all shapes and sizes, so it probably doesn't give you a very accurate depiction of what's actually in a store. But the down 3.7% does relate to the 875 stores that are go-forward. It is not in the closing stores.

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**Kimberly Greenberger** - *Morgan Stanley - Analyst*

Okay, thanks so much.

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**Operator**

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone have a wonderful day.

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