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# EDITED TRANSCRIPT

JCP - Q2 2018 J C Penney Company Inc Earnings Call

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## OVERVIEW:

JCP reported 2Q18 adjusted net loss of \$120m or \$0.38 per share. Expects FY18 adjusted EPS to be in range of down \$1.00 to down \$0.80.



## AUGUST 16, 2018 / 12:30PM, JCP - Q2 2018 J C Penney Company Inc Earnings Call

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### PRESENTATION

#### Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2018 J. C. Penney Company 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. Mr. Kruse, you may begin.

#### Trent Kruse

All right. Thank you, Jewel, 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 16, 2018, 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 these slides, these slides are meant to facilitate a review of the company's results and to be used as a reference document following the call.



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Today, you will first hear from our CFO, Jeff Davis, who will provide a business update on our Q2 performance and ongoing strategy. I'll then rejoin the call to provide our Q2 financial overview and review our updated guidance. Following our prepared remarks, we look forward to taking your questions.

And with that, I will now turn the call over to Jeff.

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### **Jeffrey A. Davis** - J. C. Penney Company, Inc. - Executive VP & CFO

Thank you, Trent. Good morning, everyone. First and foremost, on behalf of the office of the CEO and our entire organization, I would like to thank you for your continued interest and support of JCPenney. I would also like to thank our nearly 100,000 associates across our company for their hard work and dedication. As a team, we remain committed each and every day to undertake initiatives and execute strategies that will not only help our customers find what they love for less time, money and effort, but also ensure we have the right plans in place to profitably grow and operate our business.

Turning to today's agenda. I will provide a high-level overview of our second quarter results as well as an update on third quarter and second half initiatives before turning the call back over to Trent, who will provide a more detailed overview of our results and provide updated full year guidance. We will then open the lines for your questions.

Before I do that, I know many of you have questions about our CEO search, and I hope the statement from our Chairman this morning addresses your question. As Ron said, the profit is going well, and the board has met with highly qualified candidates who have expressed their strong interest to become the next leader of JCPenney. The hiring of a new CEO is a top priority of the Board of Directors, and they will continue to expedite the process in order to bring this search to a successful conclusion.

Now let's move to our second quarter results. We delivered a positive sales comp of 0.3% in the second quarter led by our stores channel. We had a strong start and finish to the quarter. The month of May started off the quarter with a strong positive comp. However, as we've moved through to June, we experienced softer sales relative to high expectations of our sales plan. As such, we made a decision to take appropriate pricing actions on slow-moving excess seasonal inventory to prepare for the arrival of new fall and back-to-school apparel assortments. Sales regained momentum as we progressed through July, and we delivered positive comps in the mid-single-digit range for the month. Trent will provide more detail on our Q2 gross margin results in a few minutes.

From a merchandise perspective, we were very pleased to see a meaningful turn in the performance of our Women's Apparel business this quarter, which as you know, has been a major category on our part. The business outperformed the total company comp in the second quarter.

Other divisions and categories that outperformed the total company comp for the quarter included Children's, Jewelry, Sephora and Salon. And there are several divisions that underperformed, which were home, Women's accessories, shoes and handbags.

Given our focus on Women's and its recent performance, we are confident that our initiatives are having a positive impact across the business. This is evident by a positive comp sales performance we achieved in children's apparel and our beauty category this quarter, both of which also help to fund our total Q2 comp results.

Let me highlight some of the key drivers of Women's during the quarter and then briefly discuss some of the key initiatives for the balance of 2018. First, we saw continued strength on our active business, including strong results in both our national and private brand assortments.

Second, we had substantial improvement on our sales trends across our modern business and swimwear, with both delivering positive comps.

Third, our business -- our plus-size business is gaining momentum, up double digits.

And finally, Liz Claiborne brand continues to resonate with our core customer and delivered another strong comp sales performance.



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As we move to the second half of the year, we will continue to focus our efforts on improving apparel, delivering a best-in-class beauty experience, taking advantage of available market share opportunities and enhancing our e-commerce operations.

In apparel, we will continue our expansion into active through great partnerships with key brands like Nike, adidas, Champion and Puma, and expand a number of stores carrying these brands on our big and tall shops and kid's departments.

We also have very good exciting new brand launches planned this fall to further enhance our Women's Apparel assortment and build on the momentum we are experiencing in this critical category. We know that while our Women's business performs well, the balance of the assortment typically receives a lift given the strong comp across shop.

In beauty, we will further leverage our winning strategies in our higher-margin jewelry business, continue our salon rebranding rollout and deliver newness and excitement across all of our 667 Sephora locations.

As we advance our efforts and capture available market share, we will launch 500 baby shops later this month. We will now offer an expanded in-store assortment of baby hard goods and accessories, such as cribs, highchairs, strollers, car seats, diaper bags, bottles and more.

We will also deliver enhanced presentations in workwear and in toys, and partner with key national brands that are now looking for new channels to grow their business.

Finally, we're pleased to announce that just last week, we opened a new store in Kings Plaza in Brooklyn. We opened our first Brooklyn store in 2014 at Gateway Center, and this location has consistently been one of our top performing stores since it opened.

Now let's transition to some recent changes we've seen this May. Customers have [continued] shopping at JCPenney. They're finding great items of value to fill their closets and enhance their homes, along with unique beauty experiences. However, over the last few years, we've drifted from our core customer. This has hindered our ability to deliver the sales and profit expectations that we and our stakeholders have for our business. We are now taking actions to strike the right balance between an enhanced assortment and our shopping experience to deliver better top line results and profitability. That said, it is critical for us to better manage our inventory levels and focus on providing our core customers the assortment and shopping experience she expects from JCPenney. Now more than ever, we must be more intensely focused on executing upon the fundamentals of our core business. The time for discussion has passed, and the time for action is now. Accordingly, the team is taking immediate action to right-size our inventory, including an expectation to reduce enterprise inventory by at least \$250 million by the end of fiscal 2019 and better curate our assortment in line -- in stores and online.

We believe these actions provide a solid foundation that we can continue to build upon. But let me be clear, the entire organization is focused and aligned on absolute inventory levels. And we will not restrict receipt and product level to growing brands and businesses. In fact, it's just the opposite. Our actions will better support the brands and categories that are demonstrating profitable sales growth, minimize our investment and exposure across less profitable lines of business and eliminate tax currently associated with managing through high levels of inventory.

We are shifting our philosophy from buying to store capacity to buying and chasing into demonstrated sales trends. We will take advantage of the great work our teams have delivered to improve our speed to market, trend analytics and consumer insight capabilities by leveraging these capabilities. And buying to a leaner and more nimble base, we can better react to actual sell-through performance.

We know the aggressive actions we took in Q3 last year to liquidate excess seasonal inventory in Women's worked, as evidenced by the improved sales performance in the area subsequent to that reset.

Looking at where we are today, we are taking the necessary steps to mark down and clear excessive inventory positions across many of our categories, which encompasses more than just seasonal products or fashion misses. Going forward, our renewed discipline and fundamental approach to inventory management and SKU rationalization will allow us to have a sharper focus on both the quality and quantity. We will not only have the ability to drive improved inventory productivity, but also more effectively manage planned receipts and optimize our working capital.



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We are establishing several new partnerships to help us better understand the need and desires of our customers. This will enhance our buying process and allow us to leverage our speed-to-market capabilities to be more on trend, more accurate in quantities and generate higher levels of sell-through.

Additionally, improvement to our inventory position will enable us to enhance our store environment, allowing us to more effectively showcase our improved assortment and provide a better shopping experience for our customers.

All of these actions will allow us to live up to the Penney Idea, which, in the words of our great founder, "to do all in our power to pocket customers' dollar, full of value, quality and satisfaction." Going forward, we are fully committed to ensuring that every decision we make is focused on the customer. We are prioritizing a return to the fundamentals of what makes JCPenney great, providing quality customer service and delivering unparalleled style and value for all and everything that we do. With these fundamentals, once again, driving the business, we believe JCPenney can and will be a clear winner in the retail environment.

With that, I'll now hand the call back over to Trent to discuss second quarter financial results in more detail as well as outline our updated guidance for 2018.

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### Trent Kruse

Okay. Thank you, Jeff, and good morning, everyone. As you just heard from Jeff, our renewed focus on Women's is having a beneficial impact. Our ability to continue delivering a sequential comp sales improvement in Women's Apparel shows that our merchandising efforts in this area are improving. That said, we know we have more work ahead of us as we continue building a solid foundation to move forward.

Now let's turn to our second quarter financial results. Total net sales decreased 7.5% versus last year, while comp sales increased 0.3%. Our stores delivered positive quarterly comp sales for the first time in 2 years. As a reminder, the 780 basis point spread between total net sales and comp sales was primarily due to the 141 store closures in fiscal 2017, most of which were closing late in the second quarter last year. The comp sales improvement was driven primarily by an increase in units per transaction with average unit retail relatively flat for the quarter.

Geographically, the South East, Gulf Coast and Northwest regions were our best performing areas, while the Southwest and the North East were our most challenged regions.

As a reminder, starting in the first quarter this year, credit income is now included in total revenues and was previously reported as an offset to SG&A in prior periods. For the second quarter, credit income was \$67 million compared to \$83 million in the second quarter last year. This decrease was expected and is consistent with our original expectations for 2018.

As Jeff mentioned earlier, our quarter started off strong in the month of May. As we moved through June, we experienced softer sales relative to the high expectations in our sales plan. And as a result, we made the appropriate decision to accelerate markdowns in slower-moving areas of our business. We saw a rebound in sales in July and ended the quarter strong with comp sales in the mid-single-digit range for the month.

Cost of goods sold for the second quarter was 66.3% of net sales, an increase of 160 basis points compared to the same period last year.

For the quarter, we delivered an improvement in non-clearance store selling margin, which helped to partially offset pressure from higher permanent markdowns on slower-moving and excess inventory. While we are encouraged by the improved non-clearance selling margin across the store, online and within our very important Women's Apparel business, we are disappointed with the results in total.

Gross margin is a major focus for JCPenney, but our results have not delivered. And as Jeff said, the time for discussion has passed. The time for action is now. We know that with the right actions and rigor surrounding inventory management, we have opportunities to improve our current productivity and turns as well as effectively manage planned receipts, improve gross margin levels and optimize our working capital to increase free cash flow. The entire organization will be relentlessly focused on these working capital improvements, operating our business for profitable



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growth and delivering meaningful free cash flow. And looking ahead for the back half of the year, we now expect pressure on Q3 gross margins to continue, primarily due to our inventory management efforts that Jeff just discussed.

However, we believe there are other areas of opportunity that can help to partially offset this pressure, including driving sales improvement across higher-margin apparel categories, particularly Women's, continue leveraging our capabilities within our private brands and sourcing operations and further expand and emphasize our pricing analytics efforts. While it may be hard to gauge given the results, these margin initiatives, particularly pricing analytics, are delivering clear value. And we have plans to expand the scope and increase the positive impact to the enterprise.

Moving now to expenses. SG&A expenses for the quarter were \$880 million or 31.9% of sales compared to \$935 million or 31.3% of sales for the same period last year. The dollar reduction in expenses was primarily driven by lower store expenses, largely resulting from the 141 store closures in 2017 as well as corporate overhead and incentive compensation.

As a reminder, given our adoption in the first quarter of the new FASB standards associated with pension accounting, we now include the current service cost component of pension expense and income in SG&A. All other components of net periodic pension cost and income are now recorded in separate line item below operating income. Service cost does not impact our operating cash flow and is funded through our pension trust. The pension plan currently remains in an overfunded status, and no cash contributions are expected for the foreseeable future.

Interest expense this quarter was \$79 million.

During the second quarter, and as previously disclosed, we recorded an impairment charge of approximately \$52 million related to the expected sale of our 3 corporate-owned aircraft. At the end of the second quarter, we had completed the sale of 2 of the 3 aircraft and other related aviation assets for a combined net sales price of approximately \$12 million. Subsequent to the quarter, we closed on the sale of the third aircraft for \$8 million, bringing our total proceeds to approximately \$20 million, as expected.

Additionally, we completed the sale of our Manchester, Connecticut distribution facility in July for a net sales price of approximately \$68 million and recorded a net gain of approximately \$38 million in the second quarter associated with the sale of this facility.

Also during the quarter, we completed the sale of a leasehold interest of our Laguna Hills, California store for a net sales price of approximately \$33 million. Approximately \$7 million of the net sales price was recorded as a reduction to SG&A expenses in the second quarter, and the remaining \$26 million will be recorded as a reduction of SG&A expenses in the back half of this year.

Adjusted net loss was \$120 million or \$0.38 per share for the second quarter this year compared to an adjusted net loss of \$23 million or \$0.07 per share for the second quarter last year. Adjusted net loss included \$40 million or \$0.13 per share for the sale of operating assets in the second quarter of this year compared to \$1 million for the same period last year. However, it also included \$52 million or approximately \$0.16 per share resulting from that impairment charge related to the sale of the company's 3 corporate-owned aircraft.

In addition, second quarter adjusted net loss for 2018 and 2017 included the following items: \$19 million or \$0.06 per share this year related to other components of net periodic pension income compared to \$14 million or \$0.05 per share last year; \$2 million or \$0.01 per share this year related to restructuring and management transition charges compared to \$23 million or \$0.07 per share last year; \$1 million this year related to the proportional share of net income from the home office land joint venture compared to \$19 million or \$0.06 per share last year; and finally, \$35 million or \$0.11 per share last year related to the loss on extinguishment of debt.

Now let's turn to our capital structure, liquidity position and balance sheet. As expected, we utilized our ABL facility during the second quarter to fund a portion of our seasonal working capital needs and ended the quarter with \$177 million in outstanding borrowings, a reduction of \$174 million from the end of Q1. As such, our liquidity position at the end of the second quarter was approximately \$2.2 billion. We expect to have liquidity in excess of \$1.5 billion at our trough in November and over \$2.2 billion in liquidity at year-end.

Cash and cash equivalent at the end of the second quarter were \$182 million. In addition, capital expenditures, net of landlord allowances for the quarter, were \$114 million.



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Free cash flow was a use of \$235 million for the 6 months of the year and an improvement of \$186 million since the end of the first quarter of 2018.

Inventory at the end of the second quarter was approximately \$2.8 billion, relatively flat versus last year. Comp store inventory is up 1% and is primarily due to an increase in basic inventory levels and the timing of receipt flow. This increase was offset partially by reductions in seasonal and fashion inventory. We have done a much better job managing our seasonal and fashion inventory, but as Jeff discussed, we must now take action to right-size our overall inventory position.

Turning now to our updated fiscal 2018 full year guidance we announced earlier this morning. Comp store sales are now expected to be approximately flat for the year, and adjusted earnings per share is now expected to be in the range down \$1 to down \$0.80 per share.

Moving now to other key financial metrics and expectations for the remainder of 2018. Comp sales are expected to be slightly negative in the third quarter.

For the third quarter, we expect the spread between total net sales and comp sales to be approximately 100 basis points and the spread to be 400 basis points for the full year.

As a percentage of total net sales, we expect third quarter cost of goods sold to increase compared to last year, resulting primarily from our decision to right-size our current inventory position to clear excessive inventory across many of our basic categories.

SG&A dollars in the third quarter are expected to be flat to up slightly versus last year, primarily due to the timing of marketing, and free cash flow for the full year is expected to be positive.

Our teams are energized, engaged and eager to return to the fundamentals of what makes JCPenney great, providing quality customer service and delivering unparalleled style and value for all in everything that we do.

Now both Jeff and myself, along with the other members of the office of the CEO, Therace Risch and Mike Robbins, will be happy to take your questions. Jewel, we are ready to open the lines.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from Bob Drbul with Guggenheim Securities.

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### Robert Scott Drbul - Guggenheim Securities, LLC, Research Division - Senior MD

I guess, the first question that I have for you is -- so when talking about buying and chasing versus buying to store capacity, can you just address, like, your inventory plans for fall and holiday? Like, how aggressive have you been canceling orders or adjusting your orders for the upcoming seasons?

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### Jeffrey A. Davis - J. C. Penney Company, Inc. - Executive VP & CFO

Yes. Bob, this is Jeff. As we came out of last year, we had some high expectations for what we wanted to deliver for 2019. If you recall, in the back half of last year, we were up 2.4%. So as we were going through the course of this year and our sales plan -- and that high expectation versus what we were actually delivering, we did find ourselves in a situation where we have had a -- we were in an over boxed position. So we have been looking for ways to reduce our receipts where it is appropriate in some of those categories that, quite honestly, we're not seeing the sales trends and/or some of those lower-profitability categories, which, we know, we need to also manage the business for profitability. So as we go into the fall, we've





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been making some minor adjustments where necessary. We will continue to do so where we can. But also, we believe that we have a great curated assortments that our customers are responding to. And our expectations, we will continue to perform as we go through the back half of the year.

**Robert Scott Drbul** - *Guggenheim Securities, LLC, Research Division - Senior MD*

Okay. Great. And then just on the active business, can you talk about -- has there been strength, both in the apparel piece of it and the footwear piece of it and just sort of how you feel like you're positioned for that segment in the back half of this year?

**Trent Kruse**

Yes. Sure, Bob. This is Trent. I'll take that one. It's been strong across the board, Bob. I think that's one thing we all had seen for quite some time here. It's been very predictable, frankly, within the business. Whether it's private brands, national brands, footwear or apparel, it has certainly been a strong business. Very pleased with what we're seeing in both, again, these national and private brands. Expect that to clearly continue into the back half. Jeff alluded to, in the prepared remarks, expanding a lot of what we do in some of these key brands, not just within the obvious categories of Men's and Women's, but, really, expanding it into special size areas of our business, delivering a better assortment in the kid's area. As it relates to active consumer, certainly, they're looking at that product as well. And to your first question, I just want to emphasize something that Jeff said, this reduction is about reducing in areas where we're over boxed, to Jeff's point, or in areas that really aren't delivering from a style, brand or category perspective. So we feel as though we are still in a great position funding the businesses that are earning, that funding, but are making the appropriate decisions to ensure that we find the right base to move forward that allow us to have more clarity in the store, et cetera.

**Robert Scott Drbul** - *Guggenheim Securities, LLC, Research Division - Senior MD*

Okay. And then, I guess, if I could just ask one more. The -- you talked -- there's a lot of talk about at the toy category, et cetera, but you guys are pursuing some workwear initiatives. I was just wondering if you could just address how you're approaching that piece of the business and what you're excited about in that segment.

**Jeffrey A. Davis** - *J. C. Penney Company, Inc. - Executive VP & CFO*

Bob, we had some -- one of the things that I alluded to in my prepared comments is that we continue to develop great partnerships with some national brands that are looking to increase their penetration as a result of some others that are contributing share, so we're excited about some of these new brands. We'll be able to talk a little bit more about them as we go through the course of the back half of the year. But we believe that in some of the areas in which we have been collocated and are in proximity to, once again, some of those contributing market share players that our customers are responding well, they like what they're seeing, not only in workwear, but in footwear also. And we're taking advantage of that.

**Operator**

Our next question comes from Mark Altschwager with Baird.

**Mark R. Altschwager** - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Was hoping you could provide a bit more color on the guidance revision this morning, a, your Q2 results, a little over \$0.30 below. Consensus expectations that the annual EPS guidance revision would have been \$0.90 at the midpoint. That means you're looking for a loss of \$0.20 to \$0.40 in the back half. You talked a bit about sales in the release, but just with the gross margin revision versus prior expectations, is there any more color on order of magnitude of gross margin compression you're expecting in Q3 versus Q4? How much of that is the incremental inventory liquidation measures? And any changes to how you're thinking about the level of SG&A spending and the asset sales embedded in that for the back half? So a lot there, but just any more color in the puts and takes there would be very helpful.





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**Jeffrey A. Davis** - J. C. Penney Company, Inc. - Executive VP & CFO

Very good, Mark. I'll start off. And to the extent the team wants to further amplify to something I missed, please do. As we had mentioned, the first half of the year, we had essentially flat comps. What we're looking at right now is projecting that through the second half of the year. With flattish comps right now, we're going to delever a little bit with respect to sales from an SG&A perspective. But in doing so, we also want to make sure that we are making selective investments, particularly on our media mix to make sure that we have appropriate voice in the marketplace as we go through the holiday seasons. From a margin perspective, as Trent had mentioned, our expectation is that our cost of goods sold will actually increase in the third quarter of the year, but we expect the fourth quarter to actually moderate and be more in line with what we had last year Q4. A lot of that Q3 margin contraction, if you will, is going to be as a result of us continuing to address some of the excess inventory that we have. When I talk about excess inventory, it's really around in some of our basics areas where, over a period of time, we continue to allow our stores to have more inventory than what we really need in order to operate. This organization is maniacally focused on operating with less absolute inventory in order to provide a better customer experience for our customers.

**Trent Kruse**

Sorry. I just want to jump in. Mark, on the margin piece here for Q3, just to give a order of magnitude, I think if you're thinking about it in the range of about 150 basis points or so, that would be fair. And then to Jeff's comment on SG&A, certainly, I think that's where we are today. But as you guys know, from our past, we'll be diligently focused to ensure that we make the right decisions there to potentially overachieve our expectations. I think Jeff had a couple more comments to add as well.

**Jeffrey A. Davis** - J. C. Penney Company, Inc. - Executive VP & CFO

No. That was pretty much it. One of the things that I want to make sure that we do collectively as the company is that as we -- guidance going forward that we have the opportunity to meet or exceed that. And one of the things that we want to make sure that we're doing is we're looking at the business as we think that we may have some opportunity to improve, but we'll give you those updates as we go along. But as you -- as Trent had just mentioned, the headwind is really going to be around margins. And to the extent that we can improve upon that by taking the appropriate actions through our pricing analytics and we'll continue to certain take certain actions around some of the promotions that we have planned that we will be able to drive a higher level of sales and, hopefully, margins.

**Mark R. Altschwager** - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

That's very helpful. And then just on the comp, great to see the inflection. Women's Apparel, obviously, a big category for you. With the revised guidance implying flattish comps in the back half, maybe just walk us through some of the category drivers there, how you're thinking about -- what are the bigger positives, what are going to be the negatives that kind of net you out near that flat level.

**Jeffrey A. Davis** - J. C. Penney Company, Inc. - Executive VP & CFO

Sure, Mark. In the second half of the year, we have a little more difficult compare than we did in the first half. Our expectation is that Women's will continue to perform well for us. There will be some level of calendar shift, as well, in Q3. But going into Q4 in the back half of the year, we think that, that will all kind of level out. Our expectations around Beauty will continue to be the same with respect to the fine performance we're getting out of Jewelry and Salon. We're really excited about the things that we're being able to accomplish, and Trent had mentioned with respect to our special size business. Active continues to be an area that we believe that we will have a good showing in. So many of the same categories in which we've been showing performance in the first half of the year, we would expect that to continue with, unfortunately, just a higher level of stronger compare against last year.



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**Operator**

Our next question comes from Lorraine Hutchinson with Bank of America.

**Lorraine Corrine Maikis Hutchinson** - *BofA Merrill Lynch, Research Division - MD in Equity Research and Consumer Sector Head in Equity Research*

Wanted to follow up on the \$250 million of inventory that you plan to take out by the end of '19. Will we see any of the impact of that by year-end? Or will this reduction all occur next year?

**Jeffrey A. Davis** - *J. C. Penney Company, Inc. - Executive VP & CFO*

No. You will actually see some of that reduction in the back half of the year. Our expectation, once again, though, is that we will continue to manage receipt to support the business. Our expectation is that we will be in a mid-single-digit reduction by the end of this fiscal year versus 2017.

**Lorraine Corrine Maikis Hutchinson** - *BofA Merrill Lynch, Research Division - MD in Equity Research and Consumer Sector Head in Equity Research*

And then when you look at CapEx plans over the next few years, is there anything that you can pull back on just given the operational challenges maybe as a way to preserve your free cash flow?

**Trent Kruse**

Yes, Lorraine. This is Trent. I'll take that one. Simple answer is yes. I think as we're -- have been spending around \$400 million the last couple of years, we feel that's an appropriate level. But it's also included a lot of merchandise initiatives around appliance rollout, furniture, mattress, Sephora, growth and expansion, Salon rollout. So lots of merchandising initiatives tied up in there. So the simple answer is yes. We want to fund this business. We want to invest in all of the right areas. But to the extent reducing that here and there make sense, we'll certainly be looking at those opportunities. To Jeff's point, we want to be managing this business for profitability, but also, certainly, cash flow, so we'll be looking at some of those options. And there is clearly some opportunity as we think about moving into next year and some of these merchandising initiatives that, really, won't continue in terms of their significant growth or expansion that we've had over the last couple of years.

**Operator**

Our next question comes from Oliver Chen with Cowen and Company.

**Unidentified Analyst**

This is Ross on for Oliver. Just in terms of pivoting to the chasing demonstrated trends. Just wondering kind of how you're carrying out the strategy. Are you -- kind of how you identify improving trends and then if this requires incremental investment from here?

**Jeffrey A. Davis** - *J. C. Penney Company, Inc. - Executive VP & CFO*

Yes. Thanks for your question, Ross. Quite honestly, one of the things I've mentioned in the prepared remarks is that we are developing some new relationships with a few groups that are helping out identify not only trends, but tapping into customer insight and allowing us, early in the process, to sort of curate our decisions and make decisions around the quantity as well as how we might allocate that across our fleet. So these are some of the things that we are working on. Yes, it is additional investment, and additional investment is already included in our guidance for the year. But we believe that these are actions that will help us to be actually more insightful and nimble to be able to respond to some of the trend changes, but also what our customer is -- desire and is actually demonstrating in the marketplace.



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### Trent Kruse

I would just add to that. I think I mentioned in my remarks our ability to continue leveraging our private brand and sourcing organization. This is a world-class organization that has done a lot of work to really streamline the process, reduce a lot of weeks out of the time line, which has allowed us to be much faster, much more nimble to react. So to Jeff's points on certain new partnerships to allow us to get ahead of the customer sooner in terms of trends and what they're interested in or not, that's a big part of it. But clearly, continuing to leverage a 100-year-old history of delivering great private brands and sourcing expertise, it's going to be a big part of our ability to really chase into these demonstrated trends.

### Jeffrey A. Davis - J. C. Penney Company, Inc. - Executive VP & CFO

And just to amplify one other thing that I was talking about is from a merchandising standpoint, some of these tools we've been using over the course of the last year or so has demonstrated the capability to what we've seen in our -- in Women's. The expectation, as we continue to spread that across on our other categories to gain some of those same improvements in the business, is what we're really excited about.

### Unidentified Analyst

Got it. And then secondly, just in terms of kind of capturing some market share opportunities in the back half of the year, just curious on any more specific commentary there with the category call outs.

### Trent Kruse

Yes. I think it's probably some of those obvious ones, Ross. I mean, we've mentioned toys. There's a good question earlier on workwear. Certainly, that's an opportunity for us. But it's even within existing lines of the business through increased partnerships with great national brands that are strong and some of these competitors that are out there donating share. We talked about the baby gear component of the business. So those are certainly the big pieces, but also looking at our -- in our home categories, et cetera. So it's really the things that we've been talking about, but we'll certainly be continuing to look at new opportunities. We think that will continue. But I'd say those are the key categories as we see it today.

### Operator

Our next question comes from Chuck Grom with Gordon Haskett.

### Charles P. Grom - Gordon Haskett Research Advisors - MD & Senior Analyst of Retail

Just bigger picture here. Balancing gross margins has been a little bit tricky for you guys as you've been adding some of the lower-margin categories, like appliances. When you think about the future and your cost structure, what do you think the right gross margin structure is going to be for you guys? And do you think you need to be a little bit more active in trying to get cost out the balance, what appears to be a lower gross margin structure for Penney's?

### Trent Kruse

It's a good question, Chuck. I think you hit a lot of it on the head there. It's not 33%. It's not 34% right where we've been. So we clearly have some opportunities here. We're going to look forward, not backward. We're going to make the appropriate decisions around a lot of those categories that have a slightly lower margin. But frankly, some of those categories also allow us to drive traffic, gain new customers, bring excitement into the store. So we'll never operate a store that only has high-margin categories. We've got to be balanced in the assortment and our approach. But to your point, and as we discussed in the prepared remarks, we are going to be reconsidering our efforts in some of these areas, maybe the scale and scope of this versus an outright moving away from it. But certainly, we are incredibly disappointed with where we are now. We know we've



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got a ton of opportunity to be better than what we've demonstrated on gross margin. And we think some renewed focus on inventory, a desire and push to drive some of the higher-margin categories, as we've begun to demonstrate, will certainly help. I don't think we want to get into targets or anything like that today. But certainly, it's a number that's meaningfully higher than where we are today.

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**Charles P. Grom** - *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

Okay. Fair enough. And then just on the comp. Just trying to connect the dots here. In the release and you guys said that July was ahead of the annual comp guidance range of 0% to 2%. Was that larger because of the calendar shift? I guess, that would be to first question. And then, why would you guys expect the business to slow? I think you said the third quarter would be flat if, in fact, July was strong. And I guess, the last part of the question would be, any early thoughts on the back-to-school business, thus far?

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**Jeffrey A. Davis** - *J. C. Penney Company, Inc. - Executive VP & CFO*

So Chuck, as we think about July, at some level, there definitely was a calendar shift with the back-to-school starting earlier this year in our second quarter versus our third. But if you think about the quarter in its totality, some of the performance that we saw in the second quarter, June was a month that we saw sort of a retreat. And I think the whole industry actually saw that from overall traffic perspective, some of the strong performance that everyone had in May, some of the pent-up demand from the earlier sort of first quarter unseasonably cool weather. As we go into the third quarter, what we feel really excited about is the fact that we did have some momentum. We saw a return as some of the competitors that were contributing market share, Bon-Ton, some others that, quite honestly, impacted our business, Babies R Us, we actually saw, in those particular categories, a return in baby, in Men's. And we believe that some of that is going to continue into Q3. What we do know is that there was about 160 basis points of shift, if you will, as a result of the calendar, and that's what's really putting the headwind into Q3.

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**Trent Kruse**

The only other thing I'd add, Chuck, is, I think, we're fairly excited about the return to growth in July. But we all know one month doesn't make a trend. And as Jeff alluded to throughout the call today, we've got to be more disciplined in how we plan our business moving forward, so that we don't get caught out with the wrong levels of inventory, et cetera. So we're going to do everything in our power to lead to a better result than flat. But yes, that's where we see it today.

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**Charles P. Grom** - *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

Okay. And just -- and if I could just clarify because I hopped on late. That 160 basis points, was that what you thought the benefit was in 2Q? Was that what you were speaking to, Jeff?

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**Jeffrey A. Davis** - *J. C. Penney Company, Inc. - Executive VP & CFO*

Yes, we -- yes, that's right. (inaudible)

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**Operator**

Our next question comes from Paul Lejuez with Citi.

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**Paul Lawrence Lejuez** - *Citigroup Inc, Research Division - MD and Senior Analyst*

Macy's are seeing higher credit revenue this year (inaudible) in their guidance yesterday. Yours was down a bit. Can you maybe talk about what's driving the reduction, perhaps, how appliance sales might be factoring into what you're seeing in your credit results?



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**Jeffrey A. Davis** - J. C. Penney Company, Inc. - Executive VP & CFO

Sure. I mean, our guidance for the year is we are expecting it to be down about \$45 million for the year, and we're still in line with that. We're actually seeing growth in the penetration of our credit customer, and that has been very encouraging for us. Overall balances are about the same, maybe down just modestly. But as we know, our appliance customers want that -- is a nice boost to the overall. As we move forward, we would expect that, that will continue. Appliance is an important part of our overall business, and there's nothing anything that we're seeing changing necessarily in our credit customers' actions.

**Paul Lawrence Lejuez** - Citigroup Inc, Research Division - MD and Senior Analyst

Got you. And understanding that this could change with new leadership at some point, but I am curious about your current thoughts on the role that home will play within the assortment, both over the next 12 months. And what's your view beyond that?

**Jeffrey A. Davis** - J. C. Penney Company, Inc. - Executive VP & CFO

Well, first of all, I mean, home overall is a division for us in a number of categories. It's important for us. We know that our customer comes to JCPenney for those soft and hard goods. As we move forward, we will continue to make these appliances available for her. And once again, as we think about, once again, keeping the customer in clear focus, as we think about this cross-shop opportunity, we want to make sure that we have the broadest assortment that is important for her. So we're not going to be making any decisions in the near term necessary about pulling back on certain categories. We believe, as we move forward, as she demonstrates our demand, we will be there to supply.

**Paul Lawrence Lejuez** - Citigroup Inc, Research Division - MD and Senior Analyst

Got you. Then last one for me. Any range of what your EBITDA expectations are for this year or free cash flow?

**Trent Kruse**

Yes. Sure, Paul. I'll take that one. From a free cash flow perspective, we're looking to be up slightly -- flat to up slightly. I think, again, we're going to work hard to make that a better result by the end of the year. I think if you're thinking about EBITDA in a range, plus or minus \$700 million, that's appropriate, as we sit here today.

**Operator**

Our next question comes from Kimberly Greenberger with Morgan Stanley.

**Kimberly Conroy Greenberger** - Morgan Stanley, Research Division - MD

I've got a couple of things I just wanted to confirm. The third quarter comp to sales spread, I think you talked about 100 basis point negative spread, if I could just confirm that. And then Trent, I think you talked about stores actually turning positive here in the second quarter. Do you think that was driven by the clearance activity? Or do you think there are some other swift traffic driving initiatives that might be driving that? E-commerce, was that positive during the quarter? And any color on e-commerce would be helpful. So after this clarification, Jeff, I wanted to just sort of step back for a minute and ask you about the commentary that you got directed away from your core customer. And I think from the outside, it's quite obvious to see the ways in which that has manifested itself in your business. So if you could just talk about the -- in your view, how the business has drifted away from the core customer and then what you guys are doing to get that back on track.



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**Trent Kruse**

Sure, Kimberly. I'll take the first part and I'll let Jeff answer the second. You are correct on the 100 basis point comp spread for Q3. Yes, correct on stores. It's interesting about clearance this quarter, our performance actually would have been better from a comp sales perspective without clearance. I think, last year, we were in a liquidation mode across our closing stores. So when you look at the clearance business year-on-year, it's actually a slight negative for us because of those. We have liquidations from the closing stores last year. I think we're starting to see a little bit of traction in the style and value for all components. I think, clearly, we've been pleased with some of the efforts we've had around apparel that is helping drive a better result in the store. From a dot-com perspective, it was down slightly in the second quarter, but that was intentional. And I think what's probably best now is, maybe, I'll let Therace, is here with us, just add a couple of comments about some of the actions that they're taking in dot-com to be deliberate, to put a better customer experience out there, et cetera. So Therace, if you want to add anything.

**Therace M. Risch** - J. C. Penney Company, Inc. - Executive VP and Chief Information & Digital Officer

Thanks, Trent. Over the past year, I think people understand that we've done an extensive few expansion through our digital channel. And through this process, we've learned a lot about what our customer really wants to buy digitally online and how to drive sustainable profitable growth in this channel. So as Trent mentioned, we very intentionally pulled back on our online sales as we make adjustments to that extended assortment, so we can better meet the needs of our customers. And we're focusing on improving the overall digital experience. The changes that we're making right now are going to enable us to grow this channel very sustainably over the long term.

**Jeffrey A. Davis** - J. C. Penney Company, Inc. - Executive VP & CFO

And then, Kim, you talked a little bit about my comments regarding drifting away from the core customer. Over the last several years, I think, when you had mentioned that in your own observations that JCPenney, in its desire to continue expanding its customer base, wanted to attract a younger and more trendy customer. In doing so, our assortment migrated that direction. And our core customer, we believe, is a female in the age range of 45 to 55-plus. We were no longer necessarily having the broad array of merchandise silhouettes that was most important for her. We believe that, that core customer is who JCPenney is. She influences across a broad array of individuals in her direct family and her extended family across the multiple age ranges. So we need to make sure that we win her, that we have the merchandise that is important to her, such that as she thinks about cross-shopping, not only for herself, but for her family that we then have the other products that are available and important for those individuals also. But we believe that through our Women's initiatives, not only continue to look, what we can bring back some of those great, modern and more fashionable elements that were important for the individual and the age range that I have spoken about is where we need to be. We believe that we can also meet her needs from an Active perspective. We believe, that from a Beauty perspective, once again, what we're doing in fine jewelry, what we're doing in Salon and other areas, once again, to make sure that we are the retailer of choice for her.

**Operator**

Our next question comes from Erinn Murphy with Piper Jaffray.

**Erinn Elisabeth Murphy** - Piper Jaffray Companies, Research Division - MD and Senior Research Analyst

I had a question on Beauty, overall, during the quarter. Can you just talk about what you saw between skincare, makeup and fragrance within the Sephora business? And then in September, you'll be lapping the very successful Fenty launch. I'm just curious how the merchants are kind of working to anniversary this. And then any perspective on the promotional backdrop for the overall Beauty category?

**Trent Kruse**

Yes. Sure, Erinn. This is Trent. I'll take that one. Yes, I think you're continuing to see what we've been saying. There's a little bit more promotional out there. I think for us, right, the biggest part of our business has been color, but we've seen some nice traction in our skincare business as we've



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expanded, what we offer in that category, both from a brand perspective. So I think you're seeing that play out, it's continued strength in Sephora. Skincare kind of leading the charge for us given some of our additional brands. And I guess, that additional brand comment is very relevant to your point on Fenty, right? We're launching new brands within our Sephora four walls. We're working with our great partners with Sephora to ensure that we bring together the right assortment, experience and excitement to comp that launch. Fenty, as you know, that went really, really well last year. And so I think we've got nice plans in place. We feel good about our ability to do that. And of course, having a great partner like Sephora to help us out there is a nice place to be. So yes, slightly promotional. Color and skincare still leading the business for us, overall. And I think we'll continue to be incredibly pleased with our world-class partnership with Sephora.

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**Erinn Elisabeth Murphy** - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Okay, that's helpful. And just 2 clarifications on some category performance during the quarter. You talked about footwear underperforming. Can you just talk a bit more about what was driving that? And then did that exclude the athletic piece? Do you talk about that separately? And then appliances, sorry if I missed it, but what did they comp in the second quarter?

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**Trent Kruse**

Sure. So from a footwear perspective, active has been clearly on our footwear business, and it was one of those, certainly, positive areas of that business. I think certain elements of our casual footwear assortment, et cetera, were a little bit weaker. When we look at that division in total, we also include handbags in that category, and it was a little softer for us, certainly, this year. The bigger -- I guess, the bigger drops were Men's and handbags. The balance of the assortment was certainly better. Active was -- continue to be pretty strong for us within footwear as well Children's from the plus-size down slightly. And again, I think that really speaks to some of the conversations Therace is having around the way we approach our dot-com business. It's a fairly meaningful dot-com business for us around appliances. And I think, clearly, as Jeff alluded to, and I did, we're trying to be a little more purposeful and thoughtful about how we approach the market in some of these lower-margin categories.

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**Operator**

Our next question comes from Paul Trussell with Deutsche Bank.

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**Gabriella Olivia Carbone** - *Deutsche Bank AG, Research Division - Research Associate*

This is Gabby Carbone on for Paul. So I just want to go back to home and appliances. Kind of what are you seeing in terms of the promotional environment in these categories, especially that you called out home underperformed? And do you think consumers are moving away from big ticket at all?

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**Trent Kruse**

Sure. I don't think so, at all, on a big ticket perspective. I think when you look at some of our other areas in furniture, mattresses, right, continued strong performance there. Our conversation around appliances is just very intentional, so I wouldn't look at that as a big ticket component. I think the other piece of home that I would want to speak to is, really, as we look at some of those core offerings within home, and Jeff was mentioning our sort of history and legacy in some of the soft home categories, those are areas we put a particular focus on. Those are areas we want to further emphasize and shine on for our customer. We've, I think, put a little bit too many resources against some of the lower-margin categories in home and that has come at the expense, unfortunately, of some of the more soft home and legacy businesses that we have. So as we've started to adjust those assortments, we're starting to see some trend improvement. I think as we rebalance the marketing efforts around home, yes, I think that will certainly help us as well. But from a big ticket perspective, no. I think our appliance component was really intentional. And the other big ticket category of our business, Jewelry, has been nothing short of phenomenal.





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**Jeffrey A. Davis** - *J. C. Penney Company, Inc. - Executive VP & CFO*

One thing I'd like to -- just one thing I'd like to add to that is that in the second quarter, we took the opportunity to, quite honestly, do a little test and learn. As Trent had mentioned, as we think about our marketing efforts, how we continue to market the broader brand, how we continue to market a broader promotional focus across the store, not necessarily around any particular categories, what we actually saw, while we may have had a little bit of a pullback in some of our hard lines of home, we were actually able to pretty much offset that from a sales perspective and some of the other categories as well as pickup actual conditional gross profit dollars.

**Gabriella Olivia Carbone** - *Deutsche Bank AG, Research Division - Research Associate*

That's helpful. And then just a quick follow-up. On your omnichannel initiative, you mentioned that dot-com was down slightly. Could you give us an update on how consumers are responding to your buy online, ship to store?

**Trent Kruse**

Sure, absolutely. So I think, definitely, we continue to be very pleased with -- I mean, we're seeing a lot of customers take advantage of that. We're still seeing over 80% of all dot-com orders touching a physical store in some way, shape or form, whether it's fulfilled from a store or picked up in a store. To your point, I think, certainly, still responding there. Traffic online was still strong. And so, again, I think to Therace's point, some of what we did was incredibly intentional around sort of finding the right base to move forward from and a better customer experience. But certainly, the interaction between physical and digital is very real, and the customer is very much taking advantage of that. And I think we've been quite pleased with some of the progress we've made there over the last several years in our omnichannel business. And again, she's certainly taking advantage of that.

**Operator**

And our next question comes from Dana Telsey with Telsey Advisory.

**Dana Lauren Telsey** - *Telsey Advisory Group LLC - CEO & Chief Research Officer*

As you think about this new inventory supply chain model and the chasing aspect of it, how do you feel -- how do you think about promotional positioning, the impact on margins going forward? And is this every category across the store chain? And how quickly do you implement it for holiday this year? Or how does that progress?

**Trent Kruse**

Sure, Dana. Look, that -- this is some work that's been underway for some time. And as you can imagine, some of our softer lines of business were faster than some of our other hard lines. We think about this on a category-by-category perspective. There are certain categories where speed is not really that important. And the lowest cost is what's most important. But clearly, as you think about some of the more fashionable apparel lines, right, that's where it becomes critical for us to take advantage of that. Those capabilities, I think, will show up. As we'd utilized them over the last year or so, we've seen the benefit. So I think our ability to chase in, read rate a sale is there, particularly on a reorder basis. So I think we feel quite good about some of our capabilities there. We've just got to better utilize them, frankly, and to Jeff's earlier comments, use some of the other partnerships we have around consumer insights, trends, et cetera, to help us make more informed decisions early, but then also enhance our ability to chase into those businesses. As you know, this business can be very profitable and very cash generative if we are operating with that mindset moving forward.



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**Dana Lauren Telsey** - *Telsey Advisory Group LLC - CEO & Chief Research Officer*

And then just lastly, I don't know if you had mentioned this. I apologize if it was. Any updated thoughts on the store base, whether it's size, whether any adjustments in size, number of stores? How are you looking at -- how are you thinking about the fleet?

**Jeffrey A. Davis** - *J. C. Penney Company, Inc. - Executive VP & CFO*

So we don't have any update on any other adjustments to the overall store fleet. As you can imagine, we continue to look at our store fleet in totality over time. Once again, one of the most important things for us also is that our store fleet represents a great distribution point to our customer, the ability to ship from store, have the customers pick up in store. But as we go through the upcoming weeks and we're going to the end of the year, we might be able to provide you with more update as to what our expectations would be in the coming years. But at this point, we have not made any decision to make any other significant adjustment in our overall store fleet.

**Operator**

And our last question comes from Jeff Van Sinderen with B. Riley FBR.

**Jeffrey Wallin Van Sinderen** - *B. Riley FBR, Inc., Research Division - Senior Analyst*

Just around the discussion of the core customer. I understand you feel like your -- you need to refocus a bit there. How do you go about engaging kind of, I guess, I will call it, the next crop, for lack of a better word, of 45- to 55-year-old customers as the current space ages because, I think, many of those women may not shop at JCPenney now? So just thinking about that. And then also if you could touch on what you feel is your biggest competitive differentiator.

**Trent Kruse**

Sure, Jeff. I'll take this -- the first part there around the core customer. I think -- look, clearly, we need to continue to invite new consumers into our store. And we have some great categories and partnerships like Sephora, a lot what we're doing in active, some of the great partnerships we have with key brands like Nike or Levi's or adidas, et cetera, right, these brands are relevant to the consumers, frankly, of all ages. So utilizing those as a way to draw those consumers in, certainly, benefits us. I will tell you, though, part of what we experience is life cycle, right? Consumers may not shop JCPenney when they're 35 to 40. But as things change in your life and your perspective changes, right, you change where you shop. We all know that. We all experience that. But having said that, and to your point, we've got to leverage some of these key initiatives, some of these key brands to ensure that we do drive some excitement and relevance with the younger consumer. And we're doing that across the brands I mentioned. We're doing that with different partnerships or tactics, like the relationship we have with Brooklyn and Bailey from social media influencer perspective. So I think there's lots we are doing, lots we can do. But candidly, the consumer's life cycle plays a role, too, on how she sort of interact with JCPenney, if you will. And I think we'll just continue to take advantage of that, Jeff.

**Jeffrey A. Davis** - *J. C. Penney Company, Inc. - Executive VP & CFO*

And Jeff, maybe, I'll take the question around sort of key differentiating factors and competitive edge. As we look at the business, we believe that we have great brands, both private as well as national. And the ability for our customer to be able to find great value in not only our private brands, but also what we'd be able to do with our national brands and some of the exclusive partnerships we have in place. If you think about our broader offering, the ability to offer her, not only an opportunity around apparel, but the things we've talked about in Beauty, and that's one of the things that you would not be able to find any other retailer in one place. And that goes across Salon, Sephora as well as Fine Jewelry. And we believe that these are the types of things that our customer is looking for and appreciate in our business.



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**Michael Robbins** - J. C. Penney Company, Inc. - EVP of Private Brands & Supply Chain

This is Mike. I'll add. I want to emphasize something that Trent said earlier, too, and that is the strength of our design and sourcing logistics arm. We know, based on independent study, that we are best in class. And that we own, from beginning to end, that design and sourcing logistics arm, unlike many of the other retailers out there, which gives us a great deal of control. We have a fantastic team. We have sped up the supply chain dramatically. And when things change in the world, we can adapt very quickly to what our customer wants. And I think that gives us a strategic advantage.

**Operator**

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

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