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JCP - Q1 2019 J C Penney Company Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q1 2019 JCPenney Earnings Conference Call. (Operator Instructions) As a reminder, this call may be recorded.

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

Trent Kruse - *J. C. Penney Company, Inc. - SVP of Finance*

Okay. Thank you, Dmitriz, 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-K and other SEC filings.

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

Joining us on today's call are Jill Soltau, Chief Executive Officer of JCPenney; and Bill Wafford, our CFO. Following our prepared remarks, we look forward to taking your questions.

And with that, I will now like to turn the call over to our CEO, Jill Soltau.



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Jill Ann Soltau - J. C. Penney Company, Inc. - CEO & Director

Thank you, Trent, and good morning, everyone. I am excited to speak with you today and share updates on the critical work we have underway at JCPenney to meet our near-term goals while strengthening the business for the future.

But before I move further into the progress we've made, I want to take a moment and comment on the ongoing tariff situation. There is a minimal impact on our business resulting from the 3 tariff tranches that went into effect last year, including the recent increase on the third tariff tranche that went into effect on May 10th, which increased tariffs from 10% to 25%. However in looking ahead, we do anticipate a more meaningful impact on both our private and national brands if the potential fourth tranche of tariffs does go into effect on all Chinese imports.

Having said that, our teams will continue to work through, where possible, derisking efforts with key partners. Of particular note and given our sourcing capabilities, we have been proactive in developing contingencies for sourcing our private brands for the better part of the last several years and meaningfully diversifying our country of origin. This has allowed us to significantly reduce our exposure to China which is already lower than industry averages. We will continue to monitor the situation and will provide updates going forward if necessary.

Now I want to take a step back and provide a clear view of what we are doing, what we are seeing across the business and the progress we have made since I joined JCPenney in October. Our critical focus on generating cash flow continues, as evidenced by our inventory results this quarter. Also, we have reaffirmed our guidance expectations to deliver positive free cash flow in 2019. We are working to reestablish the fundamentals of retail operations at JCPenney, and at the same time, we are building capabilities to satisfy the wants and expectations of our customers.

In everything we do, we are putting the customer at the center. We must reconnect with our customers on their terms with a deep understanding of how they live, shop and interact with JCPenney. Whether through data, focus group or one-on-one discussions with customers, associates or partners, we are listening and learning and taking action. The knowledge we are gaining provides a foundation for what we are doing right now and what we will do in the coming months while setting our aspirations for the future. We are setting the bar high while remaining thoughtful and strategic in our approach. We are taking the time needed to ensure we are making the right strategic choices. And from our research, we are testing and learning around ideas, assortment and concepts that our customers are giving us permission to create for them. There is a significant amount of work ahead of us, and I look forward to updating you as we move through our business plan.

In the meantime, everything we do will continue to be guided by the objectives I shared with you on the last call. As a reminder, these objectives are: Provide strategic clarity to the team that we will always be about serving the customer and growing in a sustainable and profitable manner; prioritize thoughtfully what we do and apply discipline to ensure we're focused on work that adds the most long-term value; build capabilities to support our priorities so the team is equipped to deliver on these goals; and finally, develop a results-minded culture focused on accountability, urgency and innovative problem-solving at all levels of the organization.

I am encouraged with the progress we've made in setting these key objectives, building the senior team and mobilizing our organization around our priorities. First and foremost, to begin the journey to achieving our ambitions in addition to making the right strategic choices, we need the right team in place as well. I am so pleased with all of the new leaders that we have added to our senior team here at JCPenney. These executives have chosen to come to JCPenney at this very exciting time. They believe in the brand and want to return it to its rightful place. As you know, in February, we named Michelle Wlazlo our Executive Vice President and Chief Merchant. John Welling joined the company as Senior Vice President for Planning and Allocation. And Mark Stinde is our new Senior Vice President over Asset Protection.

Since our last call, we have made further significant additions to our executive bench. In March, we named Bill Walker as our Chief Financial Officer. Bill most recently served as Executive Vice President, Chief Financial Officer for the Vitamin Shoppe. There, he oversaw all aspects of the company's financial strategy and execution. During his tenure with the Vitamin Shoppe, he played a significant role in reducing debt, streamlining inventory and improving operating income. Bill's firsthand knowledge and understanding of financial turnarounds will help JCPenney deliver improved results.

We also recently welcomed Laurene Gandolfo, who joined our team as Senior Vice President for Home Product Design and Development. Laurene brings with her 35 years of varied retail leadership experience, including over 21 years specializing in the Home area at both Macy's and Bloomingdale's.

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She is stepping into an exciting and newly created role, applying her significant Home experience to reestablish relevance across the company's Home categories.

Steve Whaley has joined our team as Principal Accounting Officer and Controller. Steve joined us with more than 35 years of accounting and audit leadership experience, including over 11 years with Walmart where he served as Senior Vice President, Controller and Principal Accounting Officer. There, he developed the global controllership function from both a talent and operational perspective. At JCPenney, he will lead the company's accounting operations and financial reporting functions.

We also recently appointed Trish Adams to serve as a strategic adviser to JCPenney supporting the company's transformation office. Trish has had an extensive career at Target Corporation and served in several critical leadership roles, including developing and executing their apparel and home strategies. At JCPenney, she will utilize her expertise to simplify and improve the effectiveness and profitability of our pricing and promotional strategies.

And last but certainly not least, I want to discuss the announcement we made earlier this morning of our new Executive Vice President, Chief Customer Officer, Shawn Gensch. Shawn is a highly accomplished executive with 25 years of experience in marketing and finance. He most recently served as Chief customer Officer for Sprouts Farmers Market, overseeing their brand and category marketing strategy, digital marketing, guest insights, customer relations, advertising, social media, private label brand strategy and public relations in support of its nationwide stores and e-commerce operations. Prior to Sprouts, Shawn cofounded and served as Chief Executive Officer of iAMroyalist, a mobile app-based and consumer-driven loyalty platform for middle-market businesses. Shawn also previously spent 10 years at Target Corporation in positions of increasing responsibility, including Senior Vice President of Marketing, where he led all media strategy, public relations, social media, strategic partnership and experiential and lifestyle marketing efforts. While at Target, he also led enterprise-wide marketing for their master brand and holiday seasonal campaigns as Vice President, Brand Marketing; and managed Target's loyalty program as Vice President, Financial Product Design and Development.

I am very excited to have Shawn join our team. His appointment fills a vital component of our executive leadership team and we are eager to leverage his cross-functional expertise to inspire an engaging and rewarding shopping experience for our customers. Shawn will be instrumental in developing a compelling brand identity that builds meaningful connections with new shoppers and strengthens relationships with our most loyal customers. His proven leadership in brand management, digital marketing, analytics, mobile applications and customer loyalty programs makes him the ideal candidate to join our team of highly esteemed retail experts to position JCPenney for success.

I am delighted to welcome these leaders to JCPenney to join experienced executives such as Therace Risch, Mike Robbins and Brynn Evenson. I am pleased to be surrounded by such a seasoned, energized group of leaders here at JCPenney. Each will play a meaningful role in delivering a compelling and rewarding shopping experience for our customers, and I look forward to sharing their progress with you.

Moving back to our objectives. As I mentioned on our last call, we need to improve in the fundamentals of effective retailing. By doing this, we will strengthen our day-to-day business and move towards sustainable, profitable growth. When I reference fundamentals, I'm referring to the key tenets of operating a retail organization such as creating a compelling assortment that is focused, edited, relevant and easy to shop; and marketing that communicates a strong value proposition, inspiring our customers and inviting them to engage with us more frequently.

With Michelle now leading our merchandising efforts, we are moving quickly to deliver an assortment that delights our customers and exceeds their expectations. And in his early days, Shawn will be focused on bringing clarity and certainty to the customer through our promotional communications to rebuild confidence that our customers will find great style, quality and value at JCPenney every day. We must be strategic in our focus and decision-making while moving quickly to improve and build upon our customer engagement.

These areas of focus, combined with the immediate actions we detailed on our last call, are critical in our journey to improve our business. Retail is a dynamic business with many touch points that all lead to the customer experience. We are working swiftly to build a framework and team to reestablish the fundamentals across the board with each of these touch points.

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With that, let me share some updates on the meaningful progress we have made on each of our immediate action steps highlighted on the last call which are proving valuable as we begin our journey to sustainable, profitable growth. Since we last spoke, we have made good progress on each of our immediate action steps.

First, we are continuing our efforts to reduce and enhance our inventory position. This is evident by the 16% reduction we delivered in Q1 following a 13% reduction at the end of 2018. We experienced significantly increased sell-through rates within all divisions and improved selling margins in the majority of our merchandise divisions during the quarter, which reinforces our expectations for improved overall gross margin performance in 2019. As our inventory rationalization efforts continue, we are testing a number of strategies around optimal inventory levels and assortment choice count. The goal here is to deliver an improved experience for our customers and maximize the return on investment of our inventory.

Second, we removed hundreds of thousands of unproductive and unprofitable factory-shipped SKUs from our website with almost no impact to our online sales results. This marks a significant improvement to the business as it is today and paves the way for a return to growth in our digital channels in a sustainable and profitable way.

Third, we are redesigning and improving core store processes that will benefit the customer directly. In the first quarter, we launched a new checkout process to streamline tasks and enhance the customer experience which translates into a shorter wait time at checkout. We have tested our new centralized pickup and returns area, with plans to expand this concept to 500 stores during the second quarter. This not only makes the in-store experience better, but it's a step toward a better omnichannel customer experience as well.

These are not just changes we hope will resonate with our customers, we know they are working, translating into a 4% increase in overall customer satisfaction scores as well as likelihood to recommend JCPenney.

We are listening to the customer, we are delivering and we are seeing the positive response. Beyond these recent updates, our store operations team is continuing to run and test several meaningful enhancements across core processes which may not be visible to the customer but support our business with improved store execution and labor efficiency.

Fourth, we are taking immediate action to improve our shrink results. By making the right investments, utilizing recent technology and making staffing adjustments, we will improve in this important area where we have not been strong over the last several years. Bill will provide more details on the initial improvements we are seeing in this area in a few minutes.

Lastly, we are hard at work revamping and rethinking our merchandise strategies to improve the relevance of our assortment and aligning with trends, qualities and styles that our customer want and deserve while simultaneously ensuring that we differentiate from what the competition is offering.

We met with many of our key suppliers this past quarter to share progress on our journey and get their input. They showed up with great enthusiasm and a commitment to support us as we work to put JCPenney back on track. Our partners came prepared with exciting new ideas we can bring to JCPenney, and we discussed ways we can better work together to keep up with changing customer expectations. We are already underway on some of these new ideas and initiatives. These conversations were both enlightening and energizing. Our partners are key to our success, and I am encouraged by the engagement we've seen and am appreciative of the partnership we are receiving.

Michelle has been on the job a little over 2 months, but in that short time has quickly worked to align leadership, review our back-half assortment and make adjustments where needed and possible. Enhancing our apparel areas will continue to be a key focus as we work to better align our apparel offerings with customer preferences. Improving our apparel business is critical to our success moving forward.

In addition, we are taking a diligent approach to our Home assortment as it is a key component to our business. Our previously announced decision to remove Appliances allows us to refocus our effort and refine our housewares and soft home assortments. Assorting an authoritative offering in the home store is important in order to serve the vast needs of our customer.



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Now as pleased as I am with the immediate and significant actions we have taken, this will be an ongoing process. Reestablishing the fundamentals of our business operations will take time, yet we have made solid progress and I am confident we'll continue to do so. My commitment is that we will make sound strategic decisions backed by data and will always be rooted in delivering on our customers' wants and expectations. We are acting swiftly but thoughtfully as we move the business forward.

Now I am going to turn the call over to Bill to give us a detailed financial update on our Q1 results. I'll rejoin the call shortly to provide a few closing remarks before opening the line for questions. Bill?

Bill Wafford - J. C. Penney Company, Inc. - Executive VP & CFO

Thank you, Jill, and good morning, everyone. It's a pleasure to join you on the call this morning. I'm happy to be here at JCPenney and I'm excited to work with Jill and the strong team she's assembled.

While I've only been here a few weeks now, it's very clear to me the entire organization is focused on reestablishing the fundamentals of retail and building the capabilities to deliver on the wants and expectations of our customers. We're focused on transforming and growing JCPenney in a sustainable and profitable manner. In the coming weeks and months, I will continue to focus on identifying and driving earnings growth opportunities, improving inventory productivity, exercising SG&A discipline, increasing free cash flow and further strengthening our balance sheet. I look forward to meeting and talking with each of you in the near future.

With that, let's move on to discuss the details of our Q1 financial results. Earlier this morning, we reported that total net sales for the quarter decreased 5.6% while comp sales decreased 5.5%. The comparable sales decline was primarily driven by a decrease in transactions partially offset by an increase in average transaction cost. Divisions that outperformed the total company comp for the quarter were Fine Jewelry, Children's apparel, Women's and Men's apparel; while we had softer sales across Home, Women's Accessories and Handbags.

Our best-performing categories and brands in Women's Apparel in the quarter included dresses, active, Liz Claiborne and a.n.a. For Q1, our Women's Apparel sell-through rates were up meaningfully while total selling margins in this business were also up versus last year. Next, our Fine Jewelry business continues to deliver strong sales results. We saw particular strength in categories such as Modern Bride, gold and fashion gems. Also, our Children's apparel business outperformed the company comp with category strength in young boys, our baby apparel and gear businesses. Finally, men's apparel outpaced the company comp with strength in our active, licensed and big and tall categories. Special-sized apparel continued to show strong results with our men's big and tall apparel business up double digit this quarter.

Credit income for the first quarter was \$116 million compared to \$87 million in Q1 last year. The improvement to last year is largely a function of an improved credit customer portfolio.

Cost of goods sold for the first quarter was 66.8% of net sales, an increase of 50 basis points compared to the same period last year. The increase is primarily attributable to lower selling margins on clearance inventory related to our decision to continue liquidating slow-moving and aged inventory. Additionally, our decision to exit the major Appliance and in-store Furniture categories had a combined negative impact of 70 basis points to cost of goods sold this quarter.

During the first quarter, both our store and online non-clearance selling margins were up year-over-year. Additionally as you heard from Jill, we experienced significantly increased sell-through rates this quarter within all divisions and improved overall selling margins in a majority of our merchandise decisions, which reinforces our expectations for improved underlying gross margin performance in 2019.

Going forward, our renewed disciplined and fundamental approach to inventory management and SKU rationalization will allow us to have a sharper focus on both 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. As we've stated before, we know our reality today provides a significant opportunity for us to drive meaningful improvements in gross margin as we move forward.



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First, we know a direct benefit from more efficiently managing inventory is our ability to generate significant gross margin upside through the restoration of clearance selling margins to more historical levels.

Second is improving our shrink results. We have taken an immediate reaction to improve shrink and are beginning to see improved results on recent technology investments and staffing adjustments. In fact, our security tag implementations have delivered an over 20% reduction in shrink dollars in their respective areas.

And lastly, given our decision to eliminate noncore and low-margin product categories such as Appliances, Furniture and certain online drop-shipped SKUs, we now have the ability to refocus on driving higher sales and gross margin in the areas of soft apparel and soft home.

Now moving to expenses. SG&A expense in Q1 this year was \$856 million or 35.1% of net sales compared to \$826 million or 32% of net sales in Q1 last year. As a reminder, SG&A in the first quarter last year included approximately \$40 million in onetime expense reductions related to the sale of the leasehold interest of our Paramus, New Jersey store as well as the reversal of previously accrued risk insurance reserves.

Additionally, given we adopted the new lease accounting standards starting this fiscal year, our home office lease expense is now included in SG&A expenses. As such, we recorded approximately \$5 million in expense related to the home office lease in Q1 this year. Last year, the home office lease was recorded as a separate charge in both interest expense and depreciation and amortization. When taking into account these adjustments, our SG&A decreased \$15 million compared to last year. Net interest expense this quarter was \$73 million.

Our adjusted net loss was \$147 million or \$0.46 per share for the first quarter this year compared to an adjusted net loss of \$69 million or \$0.22 per share for the first quarter last year. As I just mentioned, we adopted the provisions of the new lease accounting standard starting in the first quarter of fiscal 2019. Our prior financial statement amounts remain in accordance with the old accounting standards. The most significant impact of adopting the new standard was on our balance sheet through the addition of approximately \$1 billion of operating lease right-of-use assets and corresponding operating lease liabilities. This adoption also changed the sale-leaseback accounting for the home office, resulting in the removal of approximately \$150 million in property and equipment and approximately \$200 million in related financing obligation. The overall impact of the adoption was recorded to retained earnings and did not have a material impact to the company's income statement or statement of cash flows.

With that, let's turn to our capital structure, liquidity and balance sheet. As expected, we drew against our ABL facility during the first quarter to fund a portion of our seasonal working capital needs, and as such, we ended the quarter with an outstanding balance of \$118 million. This is \$233 million less than our outstanding balance at the end of Q1 last year.

During the first quarter, free cash flow was a use of \$268 million, an improvement of \$153 million compared to the first quarter last year. We continue to expect free cash flow to be positive for full year 2019.

As a reminder, we have very manageable near-term debt maturities with \$50 million of unsecured debt in October this year and \$110 million of unsecured debt maturing in June of 2020. We remain confident we can fund these near-term maturities from free cash flow.

Cash and cash equivalents at the end of the first quarter were \$171 million. Capital expenditures net of landlord allowances were \$67 million. We ended the first quarter with a liquidity position of approximately \$1.75 billion and expect our liquidity to be in excess of \$1.5 billion throughout the year.

Inventory at the end of the quarter was approximately \$2.5 billion, down \$471 million or 16% versus the end of Q1 last year. We remain focused on our ongoing efforts to reduce and enhance our inventory position. Both our seasonal and basic inventory levels were significantly down at the end of Q1 this year compared to the same period last year.

Additionally, we liquidated nearly all of our Appliance, Furniture and floor model inventory in Q1 following the decision to eliminate the categories. As such, our total inventory level decreased by approximately \$83 million or 2.8% during the quarter as a result of this action. We believe our inventory levels are improving as we move further into 2019. Our team remains focused as they continue to thoughtfully and efficiently work to



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clear less-productive inventory. Having said that, we expect inventory to be a source of working capital in 2019. Merchandise accounts payable was \$842 million, down \$91 million or 9.8% versus the end of Q1 last year. The reduction was primarily due to our reduced inventory position.

As we previously announced, our 2019 plans included the closure of 18 full line stores and 9 ancillary Home and Furniture stores. During Q1, we closed 3 full line stores and we expect to close the remaining 15 full line stores and the majority of the ancillary Home and Furniture stores in the second quarter. As a result, we have recorded approximately \$15 million in Q1 related to noncash asset impairments and transition cost in connection with the closing of the stores.

In closing and as you heard from Jill, there's a lot of work underway to elevate the customer experience and differentiate JCPenney from our competition. We are setting the bar high, remaining thoughtful and strategic in our approach and taking the time needed to get it right.

With that, I will now turn the call back over to Jill for a few closing remarks before we open the lines for questions. Jill?

Jill Ann Soltau - J. C. Penney Company, Inc. - CEO & Director

Thank you, Bill. Before we open the call for questions, I would like to take a moment to discuss our renewed focus on our most important asset, our customers. JCPenney can't regain its footing without reconnecting with our customers. We must reinvigorate and enhance this customer experience. We must put the customer at the center of what we do, addressing their needs and providing superior value to them. Here are a few areas we must address to achieve that.

To begin, we need to continue to make operational progress in the experience we deliver to our customers in our stores, online and throughout our merchandise assortments. We must also develop a leading omnichannel shopping experience through our highly relevant and capable network. This will require us to work on redefining our brand identity and promise, evolving it for today's digital age and enhancing the design of our online platform and physical stores accordingly. And finally, we must develop a rewarding relationship with our customers with unique benefits and curated merchandise offerings.

Ultimately, we must reinvigorate and rejuvenate this great company. JCPenney is an American retail icon that is very important to our customers, vendors and hundreds of communities throughout the country. And our commitment to all of our stakeholders, including of course our shareholders, is to reestablish JCPenney as a leading retailer in America.

As we have discussed since my arrival, this includes reestablishing and repairing the foundational practices that strengthen our day-to-day business. And as I work to complete my leadership team, we will continue to map out a comprehensive long-term strategy for JCPenney which we look forward to sharing in the coming months. I am encouraged by the early signs I am seeing in our business as we work to realize the potential that lies ahead.

In closing, I would like to thank our shareholders, vendor partners and customers for their support and patience as we work to reestablish JCPenney as a leading retailer in America. I would also like to thank our over 90,000 dedicated and passionate associates around our company for their hard work, and more importantly, for their commitment to JCPenney.

And on that note, we will be happy to take your questions. Operator, we are ready to open the lines for questions.

QUESTIONS AND ANSWERS

Operator

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



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

So I was just wondering, you've added a number of people to your team. Is your team complete now in terms of -- where do you still have opportunities to add people? Where do you think you need to add people?

And then the second question I have is just around the progression of the quarter. Can you just give us an idea on how, like, sales trends, and maybe by month and sort of what you're seeing 2Q to date?

Jill Ann Soltau - *J. C. Penney Company, Inc. - CEO & Director*

Thanks, Bob, for your question. We appreciate it. In terms of the team, as I outlined in my prepared remarks, you can listen to the significant additions we've made to rebuild the leadership team here at JCPenney. There was quite a few openings when I arrived, which was an opportunity to build the team that could lead the organization go-forward. So everything, from our Chief Merchant to our CFO, planning and allocation, asset protection, our transformation office, et cetera. And now with the addition of Shawn Gensch joining us as Executive Vice President and Chief Customer Officer, this is yet another critical role.

I would say that we're not yet complete although we have most of the key roles in place. One role that I mentioned on the last call was a senior leader of e-commerce and our omnichannel focus, and that is another role that we still have yet to hire. I will say that we have, between the Chief Customer Officer and that role, oftentimes, those capabilities cross over. And so now that we have Shawn in place, and we understand his abilities, we'll be focused on hiring that head of e-commerce and omni.

And I'll pass it to Bill to talk about quarter progression.

Bill Wafford - *J. C. Penney Company, Inc. - Executive VP & CFO*

Yes. Bob, this is Bill. Nice to meet you. In terms of the quarter, I think you'll see the months were fairly consistent for us. You would say there's a progression, but we had change in Easter timing which made April a stronger month on a year-over-year basis. But throughout the quarter, we were pretty consistent.

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

Got it. And if I could just ask, the credit income for the quarter, way up. I mean, can you give us the idea in terms of the run rate expected going forward and just sort of how we should think about that line?

Bill Wafford - *J. C. Penney Company, Inc. - Executive VP & CFO*

Yes, Bob. I mean, that was a little more indicative. We do have an improving credit customer portfolio. But I think where -- you would want to look at that as more flat on a year-over-year basis. And this is more timing in the quarter relative to the prior year versus any significant increase of that magnitude for the full year.

Operator

And the next question comes from Lorraine Hutchinson with Bank of America.



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

Bill, thanks for laying out the gross margin drivers. I thought it looks like some interesting opportunities. I was wondering if you could give us a sense of how much upside do you see to each of those 3 buckets? And if you have at this point come up with a target that we should think about over the longer term for gross margin.

Bill Wafford - *J. C. Penney Company, Inc. - Executive VP & CFO*

I think that's something we're still working towards in terms of how do we think about gross margins. Obviously, we knew that we would be impacted by the clearance, taking out the Appliance business and the clearance of unproductive inventory. We're still working to refine our pricing and promotional approach and how do we think about gross margin on a run-rate basis. So I think we're -- that's still a work in process, not something that we're going to put a target number out there yet.

Jill Ann Soltau - *J. C. Penney Company, Inc. - CEO & Director*

And I would just add that in addition to our pricing and promotion, as Bill mentioned, all of our inventory efforts are focused to improve our gross margin. Certainly, our shrink immediate actions that we're taking and just all the work we're doing around our merchandise assortment, there's certainly a strong gross margin component to that. So we -- of the immediate actions we outlined, 3 or 4 of them are just completely focused on gross margin. But as Bill said, it's early and we're being very diligent. But it is a strong focus for the organization.

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

Great. And then the SG&A, you talked about down \$15 million ex all the charges or noises. Is that the type of run rate we should expect for the rest of the year?

Bill Wafford - *J. C. Penney Company, Inc. - Executive VP & CFO*

I wouldn't put a target number on the rest of the year. We are making -- it is a definite focus of ours to make sure that we're being diligent with our cost. And so on a year-over-year basis, we had the onetime pickups in Q1 of last year that I walked through, right? So give you a little bit of an anomaly in Q1 this year when you look at it. I do think as we think about the go-forward business, we are being -- we're very focused on our level of SG&A spend not only as a percent of sales but just in total aggregate spend and how do we get more efficient in this.

Operator

And our next question comes from Chuck Grom with Gordon Haskett.

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

On the comp, I think you had originally anticipated 200 -- or 250 to 300 basis points of a headwind from Appliances or liquidation of Appliances. And 1Q was only down -- or only had a 20 basis point drag. Curious if you still think that's your expectation. And I guess, how are you guys thinking about the comp trajectory over the balance of the year?

Trent Kruse - *J. C. Penney Company, Inc. - SVP of Finance*

Yes, Chuck. This is Trent, I'll take that one. So I think in the first quarter, I'll take a step back, I would still say that our expectation for the liquidation of those 2 for the entire year is around that 2.5% level. In the first quarter, to your point, we did see actually a benefit in the first couple of months of the quarter as we were liquidating the floor models. That obviously turned into the headwind we expected in April, which gave us the sort of



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more neutral or slight negative impact. So that was really more of a function of the timing of the liquidation than anything else. So we would continue to expect that sort of full year headwind that we alluded to on the last call.

I think in terms of the full year comp progression, I'll just echo some of the things Bill has been saying here. And obviously our lack of guidance puts us in a position where we are really just trying to manage the business, look longer term. And I would say for the full year, we do expect comps down. We do expect a pressure from Appliances and Furniture. And I would say, they're generally going to be fairly consistent throughout the year in terms of the comp sales results.

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

Nice. You mean similar to the first quarter or just similar from the drag from Appliances?

Trent Kruse - *J. C. Penney Company, Inc. - SVP of Finance*

Both. I would say similar to the roughly 5.5% or so that we had in Q1. Again, not trying to give any guidance, but I would say similar. And then from a drag perspective, it would be greater in the following quarters now that we're past the liquidation.

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

Okay. That's great. And then I guess more importantly for Jill, just when you think about the comprehensive long-term strategy and redefining the brand, just maybe can just shed a little light on what you think the JCPenney brand should look like? How long you think it's going to take you to get there? And as part of that, what do you think about store fleet and your digital business evolve? How do you see those evolving?

Jill Ann Soltau - *J. C. Penney Company, Inc. - CEO & Director*

Well, as I've shared since I started and up to current day is we have been doing a ton of research both from a customer standpoint, understanding where our current customer is, who has lapsed, who's still with us, along with what's happening in the industry and the market especially where we trade and with those around us. And it's really critical that we understand all of those connection points because we can't just do what we've just done and we also are not focused on doing what other people are doing. And so everything that we're thinking about and considering and testing and learning has to do with our customer, where we sit in the industry, in the marketplace, what our opportunities are. And most importantly, through our research, what is our customer giving us permission to be for them as we move forward. And so that's sort of the broad brush stroke, if you will.

As far as our strategy, you are hearing through our prepared remarks part of what our strategy is in terms of getting our fundamentals in place. Our strategy long term will be a great balance between the fundamentals of retail and providing that strong foundation as well as transformational and/or innovative choices that we'll make to differentiate and reestablish JCPenney for the future. And so we are working very diligently on the immediate actions, as you can hear. We are also testing and learning on some early ideas of how we feel we may move forward. And we look forward to sharing that with the investor community in the coming months. The exact date is not final.

But just know that we are keeping you in mind and we want to make sure, when we do invite you in to share in more detail, that we have the right strategic choices to share. And as I mentioned, we have to take the time to get this right. There are no silver bullets in this business, there's no get-rich-quick schemes, and we have to ensure that the choices we make are correct. So I appreciate your interest. I am excited and looking forward to the day in the near future to share that with you. But we're just not ready for prime time. We need a little bit more time to make sure what we're considering will put us on the path. And then once we do share, it's a long road ahead of that. So thanks for your interest there.

In terms of the store fleet and digital, maybe I'll talk about that as a complementary relationship to one another. I won't school anyone on how the customers behaves today. But we all know that it's really a seamless experience that the customer desires, and they expect that the brand that they



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engage with, that they invest and have a relationship with, that it's seamless. And that is how we're moving forward. We're very digitally focused, and I am thrilled to have strengthened part of our team with the announcement of Shawn Gensch today. And as I just mentioned, we'll be selecting our head of e-com and omnichannel. But we have to think about how the physical footprint and the digital footprint works together to create the ultimate JCPenney experience for our customers.

Bill Wafford - *J. C. Penney Company, Inc. - Executive VP & CFO*

And Chuck, in terms of the store fleet. I mean, we can -- in terms of the count, we continue to evaluate the portfolio. Obviously in 2017, we closed a large number of stores. A little bit less obviously this year is the target in terms of the count, when it's 27 in total, right, in 18 full line and 9 ancillary. But we'll continue to evaluate that on a go-forward basis. We don't have any additional plans beyond that, what we've already communicated.

Operator

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

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

As you mentioned, as some China -- is not as great an impact for you in terms of the exposure. Can you take us through what the exposure is in terms of China?

And as you think of your proprietary brands in initial assessments that you've had, are there some that become more meaningful, some that become less meaningful?

And then you looking to enhance the handbags, the accessories and home, how do you see the strategies that are required there?

Jill Ann Soltau - *J. C. Penney Company, Inc. - CEO & Director*

Thanks, Dana. We won't share specifics around that the tariff situation or the fourth tranche. But what I would say is that we are continuing to diversify even today. When the first blush of a potential fourth tranche surfaced last fall, our team went to work to diversify additionally. And as I mentioned, that we already are more diversified than many of our colleagues in the industry.

As it relates to our assortment and our brands, we're focused on creating merchandise assortment and focus in segmented private brands that are complemented through national brands for a complete experience for our customer. And managing through tariffs, should those become a reality, would just be part of the job we do. But the focus on the merchandise is all around the customer and making sure that we're creating a great, impactful, compelling shopping experience. So although they are related, the customer really drives where we'll take the brands and the full merchandise assortment.

Operator

And our next question comes from Paul Trussell with Deutsche Bank.

Paul Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

Just wanted to maybe follow up on the improvement that you saw in sell-through rates and selling margin in a number of categories. Maybe speak to what helped drive that success. And as we think about inventory down 16%, maybe just peel that back for us, help us understand how much of the contribution to that was the actions that you took online versus the pullback in Furniture and in Appliances?



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Bill Wafford - J. C. Penney Company, Inc. - Executive VP & CFO

Sure. Yes, I'll take that, Paul. When we think the inventory reduction and where was that and what -- and how did that impact our selling margins? It's kind of the -- how do we think about all 3 of those things together. And I think the impact when you see on our in-store basis was a combination of our SKU rationalization and ability to pull back on inventory that allowed us to free up kind of space for the better-moving products. That's why you saw sell-through rates coming through. And it also allows us to have a more typical markdown cadence in some of our products, right? And so you'll see that we'll continue to work that as we go forward.

On the split between how do we think about in-store versus digital. You'll see we did -- we had cleared through a lot of Appliance and Home inventory, right? And we talked about the negative impact associated with that. I think on a go-forward basis, the way to think about that is that, hey, we've moved out of that now. And so now you're looking at how do we just look at run rate business, right, and gross margin there. We talked about the -- we were at 33.2% this year versus 33.7% last year on a gross profit basis. But we had 70 basis points of headwind from the liquidation, right? And so I think when you start to normalize that out, you can see where we start to fall and build on from there.

Trent Kruse - J. C. Penney Company, Inc. - SVP of Finance

And -- but Paul, this is Trent. I'll just simply add from -- to your -- the last part of your question on the total inventory. The majority of it, to Bill's point, was really just ongoing inventory rationalization and assortment improvements. The actions we took online with drop-ship SKUs, it didn't have a huge impact on our total inventory report, given that they were factory-ship in nature. Obviously to bill's point, the Appliances and Furniture played a role, but this is really an across-the-board reduction, basics, fashion, seasonal, et cetera.

Jill Ann Soltau - J. C. Penney Company, Inc. - CEO & Director

Paul, I would add one thing, too. You can tell that we have a lot going on. We all have components of this to share with you. Another key part of moving through our inventory at an optimal level is the idea of reestablishing and reimplementing timely markdowns. And this is a core fundamental practice of retailers, that we just had -- the company had lost their way in for a few years. And so that has helped us speed up our sell-throughs as well as keep our inventory reductions moving in the right direction.

Paul Trussell - Deutsche Bank AG, Research Division - Research Analyst

And then just a quick follow-up. I mean, you kind of spoke to I think paving the way to return to growth in the digital channel. Help us kind of think about that timetable and what exact actions need to be taken to be growing the dot-com business again.

Jill Ann Soltau - J. C. Penney Company, Inc. - CEO & Director

Right. Well, as I mentioned in my prepared remarks, we have been making improvements to our experience online by adding capabilities. The reduction of the hundreds of thousands of factory-shipped SKUs that just were not curated is also a critical first step in improving that. And where we go from here is really running the dot-com business as we would run our physical footprint from a great fundamental standpoint: Making sure the assortment is curated and right and it's what the customer wants; having the right visual merchandising, if you will; and how we bring it to life and communicate to customer; supported by great technology and experiential ways in which the customer will navigate through and utilize the site so that the experience is vastly improved. And so there's much we have to do. The great thing about improving a website is that it is digital in nature and we can move a little bit faster. And with many of our leadership roles filled now, we've got the right people thinking in the right way to lead our team. As far as timing, like everything, it does take some time so I can't guide on that. Just know it is an extreme focus of ours.



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Operator

And our next question comes from Mark Altschwager with Baird.

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

Congrats on the progress rebuilding the team. So it sounds like the base level expectations for comp declines this year may be steady with Q1. So what are the key milestones we should be watching for from a merchandising perspective through the year to gain some confidence in the path toward stabilization?

Jill Ann Soltau - *J. C. Penney Company, Inc. - CEO & Director*

Thanks, Mark. And thanks for your kind words on the team. In terms of where we go from here, my experience in turnarounds is there are a lot of things, as you can tell by what we share with you, that there's many aspects of the business that we have to right the ship, so to speak. And with that, sometimes, the business can get a little bit worse before it gets better. I'm not guiding here. I'm just saying this is my experience, that this focus -- this year, we are really focused on reestablishing what we need to and building capabilities and righting the ship, being very focused on getting results.

And so with all the aspects of the business that we've shared with the immediate actions and our focuses and now that the team is in place, we are working diligently and as quickly as we can to deliver quality and style and relevance to our customer, reestablish our engagement with them, our communications and moving as fast as we can to start seeing the increases that we all desire. We are focused on returning the company to sustainable and profitable growth. And sometimes, what's sustainable does take a little bit longer to get there. We're not making rash decisions to just get quick numbers.

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

Got it. And then as a follow-up, I know it's early with the Chief Customer Officer just announced this morning, but can you give us your high-level thoughts on how you're thinking about loyalty and personalization in the context of your traffic-driving strategy? Just anything on your key priorities on that front would be great.

Jill Ann Soltau - *J. C. Penney Company, Inc. - CEO & Director*

Yes. In Shawn's early days, he'll be very focused on personalization and engagement and reconnecting with the customer. Why I was so drawn to his experience and his passion for the customer. This is a true Chief Customer Officer, he will be the individual next to me that just always keeps the customer at the center of everything we do.

In my experience in developing digital capabilities, this is a place we'll be running after. And again, because of the nature of how we need to implement this, we'll be moving as quickly as we can and utilizing technology to help us get there. From a loyalty standpoint, we'll want to be very thoughtful on what we do. We have a loyalty program. We need to understand from his lens where it's working for us, where we can make improvement and what it needs to look like as we move forward.

Operator

And our next question comes from Erinn Murphy with Piper Jaffray.



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

Great. I guess I had -- Jill, a question for you just on the broader North American environment. When you take a step back, a lot of retailers and a lot of other brands have kind of signaled weakness in the first quarter, at least year-to-date. I mean, what have you diagnosed internally as a management team as some of the kind of predominant drivers of that transactional pressure across the industry?

Jill Ann Soltau - J. C. Penney Company, Inc. - CEO & Director

Well, maybe I'll give you my thoughts on kind of how we're operating around here and Bill may want to chime in on just more of the facts. I would tell you that we -- as you can hear, we have got a lot going on at JCPenney. And so we're very focused on connecting with our consumer, what they're telling us today, how they feel about us and then driving towards improving our processes and practices, our fundamentals. And so we have so many things that we're working on that we probably don't have the -- as clear of an impact on what's happening with the customer that maybe some of our other colleagues do because of the stability they've had in their business, if that makes sense. We're really just focused on reestablishing ourselves. But I'll let Bill add to that.

Bill Wafford - J. C. Penney Company, Inc. - Executive VP & CFO

And Erinn, I think when you look at the overall, I think everybody feels bullish on overall economy right now, right, tariff impact beside and all of that. But I think you saw a little bit of a slow down on the delay in tax refund this year relative to last year and kind of the uptick in some of the consumer spending associated with that. But overall, I think we feel confident kind of in where the consumer is heading. And you'll see that in mix results in terms of traffic out there for a number of us, right? So this isn't -- and I think we're still, to Jill's point, kind of in the same position we were before and really just focuses on kind of righting some of our fundamentals as we move forward.

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

Got it. Okay. Helpful. And then just on the beauty category, could you just talk about how that performed in the quarter? And then any change to how you and Sephora are thinking about that longer-term partnership?

Jill Ann Soltau - J. C. Penney Company, Inc. - CEO & Director

Well, we don't break down and give specifics. What I would share with Sephora is that like our apparel businesses, beauty is very important to us and we are seeing stronger trends in treatments and foundations and skincare and fragrances, whereas color has been a little bit softer, and that's been an industry trend for a bit of time here.

As it relates to our partnership with Sephora, of course, I can't truly speak to what it was like in the past, but there's also a new CEO in there. And we have had multiple connections. We are moving forward in tandem. He's very supportive of what we're doing here, is excited by it. We put new initiatives in place based on what they're doing. And I would say that as an organization, we have a renewed focus on our partnership with Sephora and I'm really excited about it.

Bill Wafford - J. C. Penney Company, Inc. - Executive VP & CFO

Yes. And again, I think our beauty business was really consistent with the overall business in the company. It wasn't really kind of up or down relative to that.



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Operator

Thank you. Ladies and gentlemen, this now concludes our Q&A portion of today's conference, and this does conclude our call. You may all disconnect. Everyone, have a great day.

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