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JCP - Q1 2018 J C Penney Company Inc Earnings Call

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OVERVIEW:

Co. reported 1Q18 YoverY total net sales decline of 4.3%. Expects FY18 adjusted EPS to be in range of negative \$0.07 to positive \$0.13.



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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q1 2018 J.C. Penney Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

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

Trent Kruse

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



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Joining us on today's call are Marvin Ellison, Chairman and CEO of JCPenney; and Jeff Davis, our CFO. Following our prepared remarks, we look forward to taking your questions.

And with that, I'll now turn the call over to our Chairman and CEO, Marvin Ellison.

Marvin R. Ellison - J. C. Penney Company, Inc. - Chairman & CEO

All right. Thank you, Trent. Good morning, everyone.

We had a strong start to the first quarter, with February and March comps ahead of our annual guidance range. However, our April results were negatively impacted by unseasonable weather, resulting in a sales comp increase of a 0.2% for the quarter. Overall, we're confident that our strategic plan is working, and this is evidenced by the sales recovery we experienced in the final 2 weeks of April when the temperatures began to normalize.

The first quarter can be summarized in 5 key points. Number one, we saw a continued strength in our beauty segment, led by Sephora, Fine Jewelry and our Salon business. Number two, we had great performance in our Home refresh initiatives, specifically appliances, furniture and mattress. Number three, we experienced a return to positive sales performance in Men's Apparel. Number four, we're pleased with the continued revenue growth in our omnichannel business. And finally, unseasonably cool temperatures in early April negatively impacted overall apparel comps and gross margin.

In fact, without the impact of weather, we estimate our comp sales would have been a plus 1.5% for the quarter. Despite the short-term weather impact in April, we're maintaining our annual guidance of flat to up 2%. We have an expectation it will continue to benefit from our Home refresh and Beauty growth initiatives as well as the ongoing enhancements in apparel. In addition, we're very encouraged that our May month-to-date sales performance exceeds the high end of our sales forecast.

Now let me discuss briefly gross margin. As you know, it's critical for us to improve the performance of our apparel categories to not only deliver improved top line results but to deliver better margin performance. And Jeff will discuss specific actions that we're taking to improve gross margin in the remaining 3 quarters of 2018. I'll take a little bit of time to add some color to our Q1 margin performance.

So for the quarter, there were 3 major factors that negatively impacted our gross margin performance. First and most significant to our gross margin impact occurred within our dot.com business. We experienced mix, supply chain and process issues that negatively impacted enterprise gross margin. All these issues have been identified, and process improvements are underway.

Second, we executed store clearance markdowns to address slow selling apparel categories. We're committed to running the business for the long run and not just the quarter. So having said that, we took appropriate markdowns and pricing actions in the first quarter to address slow-moving inventory and make room for new product.

And third, our negative comp performance in women's and kid's Apparel created gross margin pressure. We can correlate 100% of the negative comps in kid's and women's apparel to unseasonably cool temperatures in early April.

Gross margin improvement is a major focus for the company, and Jeff will outline specific strategic steps we're taking to improve performance for the balance of 2018. And in spite of the challenging margin performance we experienced, I'm pleased that we are maintaining our great expense reduction discipline, which is evidenced by a 270 basis point reduction in SG&A versus last year.

It's also important to note that many of our key growth initiatives are centered around lower-margin rate businesses. However, we see the importance of incremental profit dollars in these initiatives. And in the near term, our ability to drive margin rate improvement falls largely on delivering consistent sales growth in higher-margin categories, including apparel, Fine Jewelry and soft home while ensuring we drive operational efficiency in our dot com business.



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As we've discussed in the past, we're placing a greater emphasis on apparel. And in the quarter, we drove improved sequential performance in many of our women's categories across total Women's Apparel. We're also encouraged with the return of positive sales comps in our overall Men's Apparel business. Because apparel and Activewear will become a larger piece of our business in upcoming quarters, the improvements we've made in these categories bode well for the balance of 2018.

Growth in our Activewear area will be driven by enhancements in our partnership with Nike, adidas, Champion and Puma. And we're very excited about the upcoming launch of our Fanatics Fan Shops in 700 stores this summer.

I'll now hand the call over to Jeff to discuss in more detail our first quarter financial results as well as outline our updated guidance for 2018. I will come back and close our prepared remarks with highlights of some of the key initiatives for the balance of 2018. Jeff?

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

Thank you, Marvin, and good morning, everyone.

Before I begin, I want to remind you that starting in the first quarter of fiscal 2018, we implemented and accounted for new FASB revenue recognition standards and changes to pension accounting and have changed in the current year and prior year presentation of our financial statements. Please refer to the most recently filed 10-K for a complete understanding of the accounting of financial statement presentation changes related to our adoption of these new accounting pronouncements.

Now let's turn to our first quarter financial results. For the first quarter, total net sales decreased 4.3% versus last year while comp sales increased 0.2%. As a reminder, the 450 basis point spread between total net sales and comp sales was primarily due to the 141 stores closures in fiscal 2017, most of which were closing late in the second quarter. The comp sales improvement for the quarter was driven by an increase in average unit retail and units per transaction. Geographically, the Gulf Coast and South East were our better performing regions while the Midwest and Northeast were our most challenged regions.

Starting this quarter, credit income is now included in total revenues. Recall, credit income was previously reported as an offset to SG&A in prior periods. For the first quarter, credit income was \$87 million compared to \$83 million the first quarter of last year. Jewelry, Sephora, Men's and Salon comped positive in Q1. All divisions, except one specialty, comped positive for the combined February-March period. As Marvin mentioned in his opening remarks, our comp sales results for the quarter were impacted by cooler-than-normal temperatures in April.

The quarter started off solid with comp sales for the combined February and March period, above the high end of our full year guided range. While April comps ended down an unexpected mid-single digit, we delivered significant positive comps in the last 2 weeks of the quarter when the weather began to normalize. Cost of goods sold for the first quarter was 66.3% of sales, an increase of 240 basis points compared to the same period last year.

As Marvin mentioned earlier, gross margin is a major focus for the company. So looking ahead to Q2 and the back half of the year, the following gross margin initiatives gives us confidence that we can see improvement for the balance of the year: continued execution of pricing analytics and markdown optimization; efficient purchase and allocation of inventory based on sales volume versus square footage; and enhanced e-commerce channel to drive greater profitability through improved operational disciplines and continued sales improvement across higher-margin apparel categories, namely Women's.

Moving now to expenses. SG&A expenses for the quarter were \$826 million or 33% of sales compared to \$938 million or 34.7% of sales for the same period last year. The reduction in expenses was primarily driven by optimizing controllable costs in more efficient marketing. In addition, as we discussed on our last call, the remaining amortization of \$30 million gain on the sale of a leasehold interest last year was recorded as a reduction of SG&A expenses.



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Turning now to our adoption of new accounting standards. As I mentioned earlier, we implemented new FASB accounting pronouncements starting in the first quarter. The impact of full year adjusted earnings related to the new revenue recognition standards is expected to be approximately \$7 million or \$0.02 per share.

In addition, given the new FASB standard associated with pension accounting, we now include the current service cost component of pension expense and income in SG&A. The net impact to full year adjusted earnings related to the adoption of this standard, the majority of which is related to the service component -- cost component is expected to total approximately \$32 million or \$0.10 per share.

All other components of net periodic pension costs and income are now recorded in a separate line item below operating income. It is important to note service costs do not impact our operating cash flow, and it is funded through the pension trust. The pension plan has a current funded status of approximately 102%, and we do not expect to make any cash contributions for the foreseeable future.

Interest expense was \$78 million this quarter versus \$87 million last year. During the first quarter, we completed the sale of our Milwaukee, Wisconsin distribution facility and recorded a gain of \$12.5 million. In total, we recorded net real estate gains of approximately \$17 million or \$0.05 a share in the first quarter of this year compared to \$117 million or \$0.38 per share last year related to the sale of our Buena Park distribution facility in the first quarter of last year.

Now let's turn to our capital structure, our liquidity position and our balance sheet. In February, we used available cash on hand to retire at maturity \$190 million of notes due February 15, 2018. During the quarter, we also issued \$400 million in senior secured second priority notes due 2025. We used the net proceeds from this transaction to successfully complete a tender offer for \$375 million of aggregate principal amount of our outstanding unsecured 2019 and 2020 bonds. As a result, we now only have \$50 million of debt maturing in October of 2019 and \$110 million maturing in June of 2020.

Our capital allocation priority remains to deleverage the balance sheet through debt retirement at maturity or proactive refinancing and to rebuild cash balances. We remain confident to fund near-term maturities from free cash flow. As expected and given the \$190 million in cash utilized early in the quarter to retire the February notes, we drew against our credit facility during the quarter to fund a portion of our seasonal working capital needs. We ended the quarter with an outstanding balance of \$351 million. As such, our liquidity position at the end of the first quarter was approximately \$2 billion.

Cash and cash equivalents at the end of the first quarter were \$181 million, which was \$182 million less than the end of the first quarter last year. Our reduced cash position is primarily attributable to the February \$190 million debt repayment. In addition, capital expenditures, net of landlord allowances, for the quarter were \$103 million. During the first quarter, free cash flow was a use of cash of \$421 million, an increase of \$128 million compared to last year's use of cash of \$293 million.

Inventory at the end of the first quarter was approximately \$2.9 billion, down 1.4% versus last year and up 2.6% on a comp store inventory basis. The increase in comp inventory is primarily related to floor samples associated with additional appliance and mattress showrooms and the expansion of extended sizes in Active's assortment.

Our teams remain committed to effectively manage the inventory levels without sacrificing customer availability. We recently appointed a new Senior Vice President of Planning and Allocation, who comes to us with a strong retail background in P&A. Under her leadership, we will enhance our focus to better assess the effectiveness of our inventory position and make informed decisions on inventory productivity and improve our planning and forecast capabilities.

Merchandise accounts payable was \$933 million, up \$40 million versus the first quarter of last year. The increase was primarily due to the timing of receipts.

Turning now to the fiscal 2018 guidance and the update to adjusted earnings per share we announced earlier this morning. Starting this quarter, we implemented new FASB revenue recognition standards and changes in pension accounting. As such, we are updating our full year guidance



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for fiscal 2018 to only include the previous mentioned \$0.02 impact from the revenue recognition items and the \$0.10 impact from pension-related costs to our adjusted earnings.

Our new guidance is as follows: we expect comp store sales to remain in the range of flat to up 2%, and adjusted earnings per share is now expected to be in the range of a negative \$0.07 to a positive \$0.13 per share.

Now moving to other key financial metrics and expectations for our Q2 of 2018. Comp sales in the second quarter are expected to be in the middle of our annual guidance range. We expect second quarter cost of goods sold to decrease compared to last year. SG&A dollars in Q2 are expected to be down versus last year.

In closing, we remain focused in 2018 on improving inventory turns to increase free cash flow and improve margins and delivering greater operating productivity.

With that, I'll now turn it back over to Marvin.

Marvin R. Ellison - J. C. Penney Company, Inc. - Chairman & CEO

Thank you, Jeff. We'll remain focused on executing our 3-part strategic framework of private brands, omnichannel and increasing revenue per customer. We have key initiatives in place that give us confidence in our ability to achieve our 2018 financial objectives.

First, as we've already discussed, a key focus this year is enhancing our apparel offering to better align with customer preferences. We'll remain focused on categories that offer the greatest opportunity for growth, particularly special sizes, Activewear, dresses, contemporary and casual sportswear. Specific to special sizes, we're pleased with the performance of our plus-size Liz Claiborne brand. And we're also very excited about our partnership with Shaquille O'Neal, who is the definition of big and tall. We believe that JCPenney can leverage our unique position in the market place to achieve \$100 million growth opportunity in special sizes in 2018.

Our second key area is Beauty. We have a significant opportunity to leverage our total beauty experience. One of the critical components of our beauty strategy is our continued best-in-class partnership with Sephora. After opening 72 new Sephora locations in 2017 and adding 27 more this year, Sephora inside JCPenney shops will operate in over 75% of our stores. We're also excited about a series of new launches and brand expansions that we have planned in Sephora for 2018. We'll keep you updated on the timing and successes of these launches on future calls.

Also in 2018, we plan to rebrand and remodel another 100 salons to Salon by InStyle. And as a reminder, when we remodel a salon, the sales performance in these salons improve, on average, 400 basis points. Additionally, Fine Jewelry is a key component of our beauty strategy, and our jewelry business comped positively in every quarter in 2017 and was the highest comping division in Q1. Our jewelry business is bringing a new and younger customer to JCPenney, and we have aggressive plans for the balance of 2018.

And finally, we recently partnered with Fit Bit to introduce a line of health and wellness products into our assortment. We're in the early stages of this new partnership, and we look forward to expanding the health and wellness areas of the JCPenney business. JCPenney is the only retail that can offer our customers a total beauty experience combining Sephora, Salon and Fine Jewelry under the same roof.

And third, we are continuing our commitment to becoming a world-class omnichannel retailer. And although we experienced some process challenges that impacted gross margin in Q1, we're pleased that today, approximately 80% of our existing inventory is now eligible for free same-day pickup, 100% of our brick-and-mortar store network is being utilized for online fulfillment and nearly 40% of our dot.com orders are picked up in the store. And while in the store, over 1/3 of the customers make an additional purchase. Through an enhanced collaboration across all digital functions, we're merging our e-commerce operations with the latest innovation in IT to ensure that our omnichannel strategy enables JCPenney to be a high-performing, fully integrated digital enterprise.



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And finally, we continue to position JCPenney to take market share from ailing competitors. One area where we see significant share capture opportunity is in our Home refresh categories. Over 70% of our customers are homeowners, and we have a large competitor in the space donating market share.

This is arguably the most challenging and competitive retail market that we've seen in over 50 years. And over the past 3 years, we've taken significant steps to derisk our business and improve our balance sheet. Specifically, reducing outstanding debt levels and proactively refinancing. These financial improvements have stabilized our company and position JCPenney to take advantage of available market share opportunities as other retailers continue to struggle.

To that point, we have identified over 300 malls where we will aggressively pursue sales opportunities given to us by other retailers in 2018. And the vast majority of these malls are highly rated and will provide incredible market share opportunities as we continue to enhance our merchandise assortment, which includes appliances, mattress, furniture and workwear. In addition, we see opportunities to capture market share in baby gifts, footwear and our new toy category based on the competitive dynamics.

In closing, retail in the U.S. is a multitrillion dollar industry, and we believe there could be multiple winners. Those retailers who can offer their customers a value while providing the best in-store and online experience will be winners. And as a company, JCPenney plans to be one of those winners.

So Kevin, with that, we'll open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first 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*

Can you give us an update on your free cash flow guidance? Or are you reiterating that this morning? And then secondly, if you could just talk a little bit about the opportunity to reduce the levels of inventory in your stores and how much cash you think that could drive over the next few years.

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

Lorraine, this is Jeff. So we are continuing to reiterate our free cash flow guidance for the year in the range of \$200 million to \$300 million. As it relates to the inventory, we do believe that we have an ongoing opportunity to induce -- reduce our inventory levels. If you take a look at our weeks of supply on hand, there's definitely an opportunity for us. We have not provided any guidance as to what that amount would be over the course of the year. But we are working very carefully and very diligently with the new individual that I had mentioned in my prepared remarks to actually identify what those opportunities are and how we can execute them without affecting customer availability as we move forward.

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

Lorraine, this is Marvin. Just one additional point regarding strategic inventory investments. Men's Apparel was the only positive comping apparel division for us in Q1 in spite of some of the weather challenges we faced. But 2 reasons why they were able to accomplish that were investments we've made in the big and tall category and in workwear. Those 2 categories were more weather-resistant than typical spring attire, and it enabled that division to deliver a positive comp. So to Jeff's point, we want to be prudent because our overage versus last year in comp stores were driven in large part by 100 stores, where we set appliance displays, where we expanded mattress aggressively, and those were some of our best performing



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top line areas of the quarter. And so we want to balance being very, very smart and prudent on managing our working capital while continuing to drive sales.

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

And then could you quantify the gross margin headwind you faced last year as you were closing out the stores at the end of the quarter?

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

Well, from a quantification, it's difficult to do it in a very succinct fashion because it was an ongoing process. As Jeff mentioned in his prepared comments, the majority of the stores actually closed towards the end of the second quarter. So it was (inaudible) process that occurred in the first 2 quarters of the year. So it will be very difficult to kind of pinpoint on the calendar and impact. But it's obviously something that we're aware of, and something that we're managing and something that we're going to continue to understand what our compares are versus last year.

Operator

Our next question comes from Mark Altschwager with Baird.

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

Just first on the gross margin. You identified, I guess, 3 specific issues in the quarter. Any chance you could quantify the relative pressure from each of those?

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

Well, what I said in my prepared comments, Mark, is that the issues in dot.com were the most significant from a year-over-year impact. Because of some of the supply chain and process challenges that we faced, we made decisions on some holiday goods to gestate pricing in liquidation action. We did not want to carry the inventory into the upcoming quarter. We felt like, as I've mentioned, that it's important for us to run the business based on the full year, based on the long term and not make decisions that artificially make the quarter look better than the business dynamics present. But the dot.com piece was a large one. The good news is, those issues were identified, process improvements are underway. And you can easily describe it as a onetime event that we don't see facing the same pressure going into the balance of the year. In addition to that, because we had, in our minds, that we can quickly and easily quantify with our internal data, weather impacts to the business from an apparel perspective, we took action to rid some of that inventory so we could have the proper space presentation for new goods coming in. And again, that's another example of not running the business for the quarter but thinking about the whole year. And so those were kind of the 2 big things that impacted gross margin. And the good news is, is that we don't see those things repeating themselves in Q2. I mentioned that our May month-to-date sales performance is strong. We note that because I think it's important for us to demonstrate that April trend was not predicated on any macro dynamics. It was predicated on the weather because the moment weather normalized in the last 2 weeks of April, we did deliver significantly strong performance. And that strong performance was carried into the month of May.

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

The only other point I would add to that is that with the first quarter, the mix of apparel was actually down on our overall composition of our sales. As a result of that, the margin associated with apparel is a higher margin and therefore, also impacted us from an overall basis.



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

Got it. And then Jeff, just to follow up. At the start of the year, you provided some guideposts on gross margin, SG&A, credit income, just other items that built into the EPS outlook. I know there's a lot of moving pieces now with the accounting changes. But maybe just specifically, can gross margin still be up slightly for the year? And any change to your expectations on credit for the full year based on your experience in Q1?

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

So as it relates to our margin, we are expecting our margins to improve over the course of the year. What we've seen this first quarter, the decline is going to have an impact for our overall for the year. But our expectation, as we get through Q2 as well as the balance of the back half, is that our margins will continue to improve based upon the actions that we are taking. As it relates to credit income, our outlook for credit income has not changed. The improvement that we actually saw in the first quarter was as a result of some marketing funds that we had received. But at the outlook, with respect to the performance of the overall portfolio and the risk actions that we believe that we'll have to take with our partner, it will remain as we had given in our earlier guidance.

Operator

Our next question comes from Matthew Boss with JPMorgan.

Matthew Robert Boss - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

Can you help quantify the impact of the calendar shift on the -- on your 1Q comp? I guess, any sense on magnitude of the improvement that you've seen in May? And then with the second quarter guided up 1%, just any way to rank the initiative that you see in place to drive back half improvement and maybe including any update on the progressive partnership?

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

Matt, on the calendar shift, it's marginal. I mean, we can spend the rest of the call talking about shifted, non-shifted. But I think relative to our business, it's not material enough to get into the nuances of it. Relative to the growth areas for the balance of the year, we have quite a few to add that we still have a significant amount of confidence in. Beauty is a significant part for us because it is weather-resistant. And also it provides a level of differentiation and brings an increased level of relevance to our stores. So we have 27 Sephora openings, 100 InStyle salons being renovated and we just have a very strong and vibrant jewelry business that's going to continue. We mentioned Active where we're opening 700 Fanatics shops this summer. We are very excited about that because we are arguably behind in the Activewear trend, and we think this gives us the ability to catch up with a really unique and differentiated brand partnership with Fanatics. We have great expectations for our Home refresh business. We have 100 non-comp appliance showrooms, we have 300 non-comp mattress showrooms, and we have a new brand that we won't comp against in Frigidaire until the back half of the year. We continue to see improvements in our toy business, specifically with the competitive dynamics in the marketplace. And we're not trying to be #1 in market share in toys, but it's a great addition to the basket, and we're seeing great attachment data when the customer buys toys, how she goes to other parts of the store and buys other categories. Dot.com continues to grow for us, and we're excited about the operational changes we've made, the structural changes we've made, and we think that business is going to only continue to be a strong and incredibly important part of our portfolio. And last but really most important is apparel. I mean, we spent an enormous amount of time over the past 18 months, I mean, fixing our apparel assortment and making the necessary changes. That is really reflective in how well Men's Apparel performed in spite of some weather challenges we saw in the Midwest and the Northeastern parts of our geographic areas. And when we look at Women's Apparel, we can see specific indications that, that business is very healthy when we have seasonal weather trends, the same with Kid's. And so Apparel is the most significant initiative for us to grow positive comps. And again, without some of the challenges we faced in the first quarter, we think it would've happened. So all of these things give us a significant amount of confidence that we'll continue to meet or exceed our sales guidance for the balance of the year. And we're going to continue just to execute along those lines.



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Matthew Robert Boss - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

Great. And then just a follow-up. On the expense front, what's your estimate for underlying asset sales gain this year? And I guess, as we think about core SG&A, how much low-hanging fruit do you believe remains with your controllable cost? And as you think about the marketing side, do you think you're leaving any sales on the table as you continue to reduce marketing spend?

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

So I'll talk about the marketing side. I'll let Jeff talk about asset assumptions. For marketing, we talked about marketing efficiencies. Our impressions were actually up 13% for the quarter. So we don't see what we're doing in marketing as a detriment to share of voice and a detriment to driving traffic. If you combine our online and store traffic, I mean, we had positive traffic because as an omnichannel retail, you just can't look at traffic the traditional way. So we believe that the changes we're making in marketing, shifting more one-to-one, backing away from preprint, investing those dollars into digital, social and radio gives us the ability to be a lot more nimble. And so we feel confident that our marketing strategy is not only efficient but is driving increased impressions and share of voice. And then we're going to continue to modify and continue to tweak it. But we don't have any concerns about that. I'll let Jeff take the rest of your questions.

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

Sure. As it relates to asset sales and gains associated with that, at the beginning of the fiscal year, we had given guidance of \$50 million to \$60 million of gains that we would expect over the course of the year. In my prepared remarks, I had outlined what we had actually achieved in the first quarter associated with the sale of the Milwaukee facility. As it relates to SG&A, we believe that we continue to have opportunities in SG&A, specifically as we take a look at our overhead cost. But also this year so far, at the beginning of the quarter, we had already taken some actions as related to our operations above store level as well as a few areas here at home office. We continue to want to find ways to be very disciplined, continue to find ways to, quite honestly, reshape our expense curve as we take a look at our national footprint. And we still believe that we have some opportunities across the business in order to achieve that.

Operator

Our next question comes from Paul Lejuez with Citi.

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

You talked about a strong March. But just curious -- I think March should have been helped by Easter. So I'm curious if you can maybe talk about March ex the Easter shift, maybe March, April, together around that Easter period. And then as -- I know you said that sales were decent in February and March. I'm curious if you had already picked up the pace of markdowns at that point? Or if you look at the sales gross margin equation during the February-March period as being a strong one? And then I guess related to that, if the margin pressure was just in April, what were the specific actions that were taken from a markdown perspective? And over what period to cause such a big impact to the quarter?

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

Well, specific to the months, when we look at February-March, shifted, unshifted, that the business was very strong. When we look at April, to provide some color, the first 2 weeks of April were negative 12 and a negative 24 comp, and that's when the weather was really difficult for us up north. The last 2 weeks were a plus 9.5 and a plus 10. So that gives you some perspective on the dynamics of the month of April. And so we have good analytics where we can look at trends of businesses based on weather, based on sell-through, based on geographic locations. And we feel pretty confident in our analysis on how weather-impacted our specific company and also how it impacted Apparel specifically. And as we look at the month of May, when you look at shifted and unshifted, we're above our forecast, and Apparel is performing significantly strong, specifically in Women's Apparel. And so it gives us confidence that we made the right strategic decisions. Relative to the markdowns and relative to gross margin,



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we took actions throughout the quarter. There was no designated period where we did more or less. April really hurt us from a sales perspective. But when we were looking at the decision we had to make specific to some of the goods that were challenged in the online area due to process and some supply chain issues, I mean, we took those actions obviously in the earlier part of the quarter to liquidate them out and to just take aggressive pricing action. That was the most significant impact to our gross margin reduction versus last year. Because we had to take aggressive steps to exit out product that was not very desirable based on the time frame of the year. And we did not want to carry it into the balance of the quarter or carry it into the balance of Q2. And so those were the most aggressive steps that we took to address those issues, and they had a dramatic impact on gross margin.

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

Got you. And then just one follow-up. Can you talk about your plans in the lease-to-own business, timing of that? And what's built-in to your guidance for that business this year?

Marvin R. Ellison - J. C. Penney Company, Inc. - Chairman & CEO

There's really nothing in the guidance. We're testing it. The thing that we want to make sure that we understand is are we providing a service to the customer. At the end of the day, we want to make sure that we give a customer, that may not have the financial wherewithal to purchase something like an appliance but they need it, the ability to do it that can fall within their financial means. And so that, we're testing in a couple of different markets, a couple of different iterations. It's still early, but we hope to have some clarity on kind of what we can and cannot do as we get into the second half of the year.

Operator

Our next question comes from Jeff Van Sinderen with B. Riley & FBR.

Richard Frederick Magnusen - B. Riley FBR, Inc., Research Division - Associate Analyst

This is Richard Magnusen in for Jeff Van Sinderen. We know that you've been increasing penetration in some of the athletic and athleisure brands. But can you provide more detail at how you are evolving the women's assortment? And any changes we can expect for the back-to-school season in the fall time frame this year? And also with omnichannel infrastructures so could you give us an idea of what we can kind of change expect to see for the omnichannel for back-to-school then holiday this year? And then lastly, are you seeing any impact from the Bon-Ton liquidation?

Marvin R. Ellison - J. C. Penney Company, Inc. - Chairman & CEO

Okay. Well, look, I will -- I'll take the Bon-Ton piece. I have our Chief Customer Officer, Joe McFarland here, and I'll let Joe talk a little bit about Women's Apparel going into back-to-school. Then we have Therace Risch here, our Head of IT and Digital, and I'll let Therace just talk a little bit about some of the structural organization of changes and some of the things we're doing to drive really the key part of our omni business, which is mobile. As it relates to Bon-Ton, we have not seen any material impact to our business with the Bon-Ton closings. Just to give you some context. We have 97 malls that we share with Bon-Ton. That number was 107, but over the course of the last couple of years, they closed stores. As they liquidate, we've seen really no material impact to the business. We believe that's, in part, because those stores were -- had very low inventory levels before the liquidation started. So there's not a lot of product to speak of that's driving traffic and that we think will cannibalize our businesses. Obviously, we're keeping a very close eye on that. And we're going to follow it in -- with intent detail. But as we look at our other competitor, Sears, conversely, we share over 350 malls with Sears. And we've had 100 Sears stores closed in malls we've shared over the course of the last, call it, 3 years. So we have a really good understanding of the impact to our business when a Sears closes, and the net effect is positive. And it was positive even before we were strategically introducing categories like appliances and categories like mattress and categories like workwear. So as we've introduced those specific categories, when we see a Sears close, it's a greater significant benefit to our business in the whole end-to-end process. So it's a dynamic marketplace. We are paying very close attention to it, and we're prepared to make sure that we can gain market share where it



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makes sense. So I'll let Joe talk a little bit about Women's Apparel for back-to-school and what's coming. I'll let Therace talk a little bit about mobile and some of the other steps we're taking to continue to drive digital. So I'll let Joe take it first.

Joseph Michael McFarland - *J. C. Penney Company, Inc. - Executive VP & Chief Customer Officer*

All right. Thanks, Marvin. From a Women's Apparel standpoint, we continue to be very pleased with the work that Jodie and her team are doing in Women's Apparel. So specific categories, beginning with Active, we continue to see great growth in our Active brands. We will be leaning more heavily into Nike as we move forward, the expansion of adidas and the other Active brands and also our own private label Xersion brand. So we continue to see great progress for the quarter. Our Women's Active business grew double digits. Breaking it down into the more traditional customer, we're very pleased with the sequential improvements we see in our modern wear, things like Worthington, things like a.n.a. And so we'll continue our refined approach to the mix, to what the customer is responding to. In addition, our Liz Claiborne brand, we saw great success in Q1. We have continued plans to continue to lean into the Liz Claiborne brand and improve -- and continue to improve the overall Women's. And then finally, from a Women's Plus, the work the team continues to execute in the all plus-size businesses across the entire store, we're pleased with what we're seeing there.

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

We've made significant investments in our e-commerce technology platform over the last 18 months, including, as Marvin called out, our mobile platform. This has been very important to set the stage for what we're starting to work on now, which is creating a very much inspiring experience on the website. This is going to enable us to drive sales for Apparel and Fine Jewelry, which will improve our overall e-commerce profitability. And we are also doing quite a bit of work to better connect the stores experience with the e-commerce experience so that we're more seamless for our customer. So I'm excited that our technology platform is largely in place and that we can shift to a better customer experience going forward.

Richard Frederick Magnusen - *B. Riley FBR, Inc., Research Division - Associate Analyst*

Okay. And I have 1 last question. Can you give any more details in the new facility in Hesperia that you announced a couple of days ago? And maybe exact size and region it will service?

Trent Kruse

I'll take that one. This is Trent. No details. I mean, that's a replacement of our existing facility in Buena Park. It will do -- it will service what that facility was servicing, frankly. So no meaningful updates. We're excited obviously to have a brand new facility, lots of great technology in place. It will certainly enhance our capabilities on the West Coast.

Operator

Our next question comes from Kimberly Greenberger with Morgan Stanley.

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

Marvin, I wasn't really sure I understood what happened with the e-commerce business. I think you talked about some issues during the first quarter. Would you mind just elaborating on that and then talk about the fix that you've got in place now? And then in the call-outs for the strongest categories here in Q1, you didn't mention appliances. Can you just talk about the appliance performance in the quarter? And any additional rollouts of appliance sort of shop in shops as we get throughout the year?



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Marvin R. Ellison - J. C. Penney Company, Inc. - Chairman & CEO

Okay, Kimberly. For appliances first, we delivered a 15% comp in appliances for the quarter. It exceeded our internal forecast, and we are very pleased with that business. We're in the process of evaluating how we can make that business work with a smaller footprint because we have stores that are just square footage-constrained. And so as we can figure out through test and pilots how to create a smaller footprint that we can possibly put in the smaller square footage stores, we'll see the possibility of improving or expanding the number of locations that we have. We're pleased with our performance thus far, and our best performing stores tend to be stores that share a mall with Sears, which gives us confidence that we can compete head-to-head very well. Relative to gross margin and e-commerce, we have to take pricing actions and clearance actions to liquidate dot.com holiday inventory. This was due to some supply chain process issues that prevented holiday product from properly flowing through the dot.com distribution centers in a timely way so that we can get it shipped to consumers. The good news is, is we have store-fulfillment capabilities. So we didn't lose sales because the moment that order was made and identified, the system ordered it and picked and ported from a store location closest to the customer's ZIP Code, which was great for sales but it masked the issue that we were not effectively leveraging the supply chain capabilities to get the product in the band, meaning in the DC, to be picked and pulled. So if something has been identified, we put structure process and teams in place, and this will not occur again. But it impacted the business. And when we came to the realization that we had inventory that was not properly executed in the supply chain, we took action on it because as I mentioned, I think Jeff noted as well, we wanted to make sure that we made the prudent decision for the business for the long-term and not carry that inventory into the next quarter. So we took really aggressive steps to exit it, and those steps were the most significant impact to our gross margin.

Kimberly Conroy Greenberger - Morgan Stanley, Research Division - MD

That's very helpful. And then Jeff, I just had a follow-up on SG&A. Could you just describe the reduction in leasing expenses associated with remaining amortization of a gain on sale of a leasehold interest last year? Is that finished? What is that item exactly? And is this the only quarter when you should see an -- when we should see an impact from that?

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

Yes. So you may recall that last year, we had sold the Paramus, New Jersey facility, which we are actually closing this fiscal year. And in that transaction, we realized a \$50 million gain. \$20 million of the \$50 million was recognized last year, and \$30 million of it was recognized this year. Given the fact that we were actually leasing back that property from the landlord for a certain period of time, we had to offset the gain against the lease expense and SG&A. And it's just an accounting sort of standard that we had to comply with. It is now complete. We would not have any more amortization associated with that transaction.

Operator

Our next question comes from Paul Trussell with Deutsche Bank.

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

Last year in the second quarter, I think it's fair to say that was a dynamic time for the company. You had a number of store closings and liquidation sales ongoing. So just asking for maybe a little bit more handholding on how we should think about the amount of recovery possible or expected in the merchandise margins for 2Q. And also, you outlined already, I believe, expectation for SG&A dollars to be down in 2Q. Can you talk about any potential magnitude and what the drivers of that cost reduction are?

Marvin R. Ellison - J. C. Penney Company, Inc. - Chairman & CEO

Paul, this is Marvin. I'll take it first. So Jeff mentioned that we expect gross margin to improve year-over-year in Q2, and we expect SG&A to be down. SG&A decline is driven in large part just by continued efficiencies in the business. I mean, we're really pleased with our performance in SG&A over



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the last couple of years. When we started on this path, we were significantly higher than what I believe we should be, and we've gotten the number down to a more respectable range. But we're going to continue to work on it. We think we still have structural opportunities with organizational layers that we need to address. We have opportunities to continue to invest in technology that will minimize the amount of ineffective tasks that we're taking on. In the store, Joe McFarland's team is working really hard to find ways to invest technology, reduce task and improve service. And we've seen that occur over the last 12 months, and we think there is still room for improvement. But there is no one silver bullet. It's a combination of a lot of things very similar to what we were able to deliver in Q1. Relative to gross margin, Jeff outlined some of the key things that we're working on and will continue to work on. Things like continuing to have more dynamic pricing and leveraging data from a pricing standpoint, continuing to understand which promotions are accretive from a customer response as well as top and bottom line, ensuring that we look at -- continue to lean into our markdown optimization, which we're having some really nice success on. A lot of work in the supply chain, as I mentioned, Therace and her team have made tremendous strides to remove some of the impediments that were really negatively impacting the company on a profit perspective. And in the explanation I just provided to Kimberly regarding the issue within the holiday supply chain and process-related issues with dot.com. That's not going to repeat itself. I'm glad we identified it, and now we understand how we cannot allow it to occur again. So it's going to be improved, and we see improvement in gross margin for the balance of the year. And so we're going to leave it at that. We're not getting into a ton of specifics because we want to make sure that we are going to be committed to just executing the plans that Jeff laid out, and there are other things we'll continue to work on to hopefully, get some upside to sales and to profit.

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

And maybe bigger picture, one of the pillars of your strategic framework is increasing revenue per customer. Can you just give us an update on how you're tracking on that front? And what are some of the more specific initiatives in order to drive that initiative?

Marvin R. Ellison - J. C. Penney Company, Inc. - Chairman & CEO

Well, Paul, what I'll tell you is that we've been very pleased with all of our strategic initiatives. Revenue per customer is defined as you are a core JCPenney customer and you shop us but you don't shop us across the entire store. And so as we think about revenue per customer, it's about introducing things to our existing customers that they are unaware that are available at JCPenney. I mean, you'd be surprised a number of customers that still don't know that we have Sephora shops in 75% of our stores. And so you've noticed more marketing along those lines and the specific line of marketing within the social media channels. We launched appliances and mattress and furniture simply because the data informed us that 70% of our customers were homeowners. Yet they were buying their furniture, mattresses and appliances in other locations. So that's an indication. When we did our fail search analysis going online to determine what customers were searching for on jcpenney.com that we didn't sell, the #1 category was toys. And so getting into that business, it's not again to be a market share leader. But to have another category that increases revenue and increases basket size when a customer is shopping. And we've -- we're behind as it relates to Activewear. And so Joe laid out some of the things that we're doing in women's. But across the store, in those 700 Fanatics shops are going to help us to take those customers that really want to have a broad assortment of Activewear and give it to them. That's something that we haven't done in the past. And the last component of revenue per customer is our special size business. We've done a lot of analysis on our customers, our customer demographic, and we understand that special sizes is something that they desire. And so our partnership with Shaquille O'Neal is to take our market share lead in Men's big and tall and lean into it even more. We talked about the performance of our Liz Claiborne plus-size women's businesses. That business is a non-comp business for the first half of the year, and we're seeing terrific results. Not to mention, our Kid's plus business, Boys Husky and Girls Plus. So all of those businesses fall under the umbrella of revenue per customer because we had customer shopping JCPenney. They wanted those categories, and we didn't sell them. And so that initiative is working well for us, and we're going to continue to execute better and continue to research our customers to find out what else they are looking for that we can possibly add to our assortment.

Operator

Our next question comes from Oliver Chen with Cowen.



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Oliver Chen - Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst

We had a question about Women's Apparel and curation and navigation in-store, just regarding the inventor levels and what you're thinking about speed and stability that test read and react as well as making sure your customer can navigate well.

Marvin R. Ellison - J. C. Penney Company, Inc. - Chairman & CEO

Oliver, we've implemented a speed calendar, and this impacts Women's Apparel more so than any other merchandising category. We have reduced the time from develop, design to sales for -- by 40%. We have certain categories in Women's Apparel that we are updating on a monthly basis. And that's something that we've never done before. So we literally have a fast lane in the supply chain for Women's Apparel. And this is primarily focused on tops because we know that the ratio of tops to bottoms is something that we want to continue to get better at. And so when we think about that, and we think about our brands and our customer demographic, that is one area that we have a high degree of optimism that's going to allow us to get this business to a positive comp. And although we know we are impacted by weather in the first quarter in Women's Apparel, the business still performed better than it did in Q4. And we are just going to continue to see this business getting better and better. And part of it is newness, freshness and the ability to create excitement on the floor with just more relevant and more recent updates to the business. And I'll let Joe just add a couple more comments on that.

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

Oliver, from a read and react standpoint, we spent a lot of time with the teams. And if you think about the new fashion sets that we've landed, both in the month of March, the month of April and then for this month in May. For the March set, we were very pleased with the increased sell-through compared to last year. The increase in the sell-through, same thing with the set -- new set of fashion that landed on our floor for our April set as well as our May set. We're very, very pleased with the improvements that we're making. The curation of the design team, the merchandising team, our private brands team and really have this pulling together and coming to life on the floor. And coupled with our new advertising campaign, we really like the early results that we're seeing.

Oliver Chen - Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst

And just a few quick ones. Regarding pricing, are you feeling good about the consumer reception of pricing and simplification in terms of being competitive on the right key items and balancing how you communicate that message. And the last thing was about store base. I would just love your thoughts as you continue to innovate across omnichannel and think about format and service levels and the right levels of CapEx and balancing lower productivity versus higher productivity stores. What is your latest framework in thinking about the physical plus the digital?

Marvin R. Ellison - J. C. Penney Company, Inc. - Chairman & CEO

So I'll take those 2. On pricing, we continue to focus on simplification. We think that in a high/low environment, we've come to the conclusion that our customers prefer personals. It helps them to understand the value proposition. But there's work that we can do in that we're testing and making that a more simplistic math equation for customers. But we also had found some benefit in being everyday price, and it works by category. Certain price points work really well when there is just a standard price and others work better when there's personal. But that is something that Therace and her team are really working with the stores on to make sure that we have more continuity between online and in-store. But we're making great progress. We've come a significant way from when we started this over 1.5 years ago. Relative to the store base, I mean, we talked a lot about omnichannel, and I think the number is somewhere around 80% of all of our e-commerce purchases touch a physical store. So stores are important, and stores will help us to reduce the delivery and fulfillment costs over time. Having said that, we know that we have to continue to invest the right level of CapEx. That's one of the reasons why we're still investing in Sephora, Fanatic shops, appliance showrooms, Men's big and tall, Women's plus. All of these require us to elevate the store presentation, and that's what we're doing. And we're evaluating our fleet, making sure that we're not going to run stores that are not productive and not adding value to the enterprise. And that's an ongoing process.



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Operator

Our last question comes from Chuck Grom with Gordon Haskett.

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

Just a couple of housekeeping things here at the end. First on the \$30 million gain, Jeff, is -- the assumption that the 50 to 60 of asset real estate deals, is it separate from that? Or is that combined?

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

It is separate.

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

It is separate. Okay. And then on the service cost. Geographically, on your P&L, is that going to flow through as a contra pension income? Or is it going to come through on the SG&A line?

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

Yes. The service cost components flows through the SG&A.

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

Okay. And then just here in 2Q, it definitely seems like April got significantly better. And if I recall back on 2Q of last year, May was your toughest compare of the year. So I guess, Marvin, do you kind of look at the 1% guide as being conservative or realistic? And how should we frame out the progression of Apparel in the second quarter?

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

Chuck, what we're trying to do is we're trying to underpromise and overdeliver, specifically on the revenue side. The key to our second quarter and the balance of our year is Apparel. And what I can say is we are very pleased with our Apparel performance in the last 2 weeks of April and the month of May. And that is going to be the linchpin for our business, and there has been enormous amount of work. So the short answer is, we look at it as an underpromise, hoping to overdeliver. And we think we're going to be driven by improved apparel performance. And we're seeing that, and that gives us confidence and gives us encouragement that we're headed in the right direction.

Operator

And ladies and gentlemen, this does conclude the Q&A portion of today's conference call, and it also concludes the conference. You may all disconnect, and have a wonderful day.



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