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JCP - Q3 2018 J C Penney Company Inc Earnings Call

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Co. reported 3Q18 adjusted net loss of \$164m or \$0.52 per share.



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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q3 2018 JCPenney Earnings Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded for replay purposes.

It is now my pleasure to turn the conference over to Mr. Trent. Please go ahead.

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

All right. Thank you, Haley, and good morning, everyone. As a reminder, the presentation this morning includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which reflects the company's current view of future events and financial performance. The words expect, plan, anticipate, believe and similar expressions identify forward-looking statements. Any such forward-looking statements are subject to risks and uncertainties, and the company's future results of operations could differ materially from historical results or current expectations. For more details on these risks, please refer to the company's Form 10-Q and other SEC filings.

Please note that no portion of this presentation may be rebroadcast in any form without the prior written consent of JCPenney. For those listening after November 15, 2018, please note that this presentation will not be updated and it is possible that the information discussed will no longer be current.

Also, supplemental reference slides are available on our Investor Relations website. While management will not be speaking directly to all of 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 me on today's call is Jill Soltau, Chief Executive Officer of JCPenney. Jill will open the call in a few moments with some brief remarks on her first few weeks at JCPenney, as well as highlight a few key focus areas for the holiday season. I will then rejoin the call to provide a detailed overview



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of our third quarter results before passing it back to Jill, who will provide some closing comments. Following our prepared remarks, we look forward to taking your questions.

I would now like to introduce JCPenney's CEO, Jill Soltau.

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

Thank you, Trent, and good morning, everyone. It is a pleasure to be joining the call this morning. And on behalf of our entire organization, I would like to thank you for your continued interest in and support of JCPenney. I'm excited to be here and to have the privilege of leading such an iconic quintessential American brand with a strong and long-lasting heritage. In the coming weeks and months, I will continue to meet with and learn from our teams throughout the entire organization, talking with them about what we're doing that's working well, and most importantly, what we can do to address our opportunities. We will be focusing our review on many areas such as customer data and perception and how we communicate with our customer, including our promotional cadence, rebuilding our merchandising capabilities, execution both in-store and online, omni-channel strategies, our retail footprint, forecasting accuracy, shrink results, and of course, inventory levels and replenishment capabilities.

While this will be a lengthy process, I understand the need for quick action. I will ensure that our decisions are made thoughtfully and carefully using all available information. 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 will act swiftly but thoughtfully as we move the business forward. While these things take time, assessing current business strategies and implementing new ones is my top priority. I will look forward to sharing my thoughts and strategies as we progress.

With that, let me share some of my initial impressions of the business. As I walk our stores, we are over-assorted and heavy on inventory, and we have a clear opportunity to provide an enhanced shopping experience for our customers. In an effort to improve the experience in assortments, we made the decision to initiate an inventory liquidation to clear through excess levels of slow-moving basic inventory. We have made solid progress on this initiative as evidenced by our inventory position at the end of the quarter.

In addition, the rightsizing of our inventory eliminates certain tasks associated with high levels of inventory and slow-moving product, which allows our great store associates to better focus on providing the excellent customer service JCPenney has traditionally been known for. All that said, we believe we can deliver profitable growth in the future by strengthening our retail fundamentals and better managing our inventory position. We know we have more work ahead of us and we are well underway with our targeted inventory reduction plan by the end of fiscal 2019.

By executing on these fundamental operational strategies, we have a sizable opportunity to improve our growth margin results, and more profitability, grow our sales. By doing so, we can mitigate markdown risks, improve profitability and more effectively leverage our working capital. As a team, this remains a top priority. And in just a moment, Trent will provide more details on some of the clear margin opportunities we have ahead of us as a result of our enhanced inventory management focus and improved fundamentals.

Now let me pivot and briefly discuss Q4. As we look ahead, we are focusing our efforts on executing well this holiday season. While most holiday business strategies were created and implemented prior to me joining the company, I have been actively involved in ensuring that JCPenney is prepared for the upcoming holiday season.

Let me highlight a few key focus areas for the holiday season. In our Women's Apparel business, we continue to adjust our assortments to deliver more profitable sales, which will add to the already improved results in that business. As we're seeing more seasonally cool temperatures, we can also begin to leverage our strength in outerwear and sweaters for the holiday season. For our e-commerce business, we are working to improve the overall customer experience in our digital channel to ensure we have a consistent experience for our customer regardless of whether she is shopping online, mobile or in-store. We will take advantage of market share opportunities from competitor store closings across many categories of our business such as toys, where we have added 40% more to our assortment this holiday season. Our Jewelry business continues to perform well for us. So we will leverage event-driven sales during the holiday as well as expanding some key bestsellers throughout the chain. And of course, offering some excellent gifts and deals with Black Friday.



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Now before we move into the details of our financial results, I want to take the opportunity to introduce and welcome Michael Fung, who has joined JCPenney as interim CFO, as we continue our search for a permanent Chief Financial Officer. As I continue to assess the opportunities surrounding the company's business, his experience, leadership and guidance will help JCPenney benefit from the expertise of a seasoned retail CFO, who has supported other retailers during a pivotal time in their evolution and help deliver meaningful progress. Michael brings more than 23 years of experience in value-oriented retail and finance operations. His knowledge and contributions will be a valuable addition to our senior leadership team as we work together to develop solutions and drive decisions that are in the best interest of our customers and shareholders.

Finally, given that Michael has been here now for just a couple of weeks, I am going to turn the call over to Trent to give us more detailed financial update on our Q3 results. I'll rejoin the call shortly to provide a few closing remarks before opening up the lines for questions.

Trent?

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

All right. Thank you, Jill, and good morning, everyone. As we reported earlier this morning, total net sales decreased 5.8% versus last year and comp sales decreased 5.4%. On a shifted basis, comp sales for the third quarter decreased 4.5%. Gross margin decreased 210 basis points, primarily the result of our decision to liquidate slow-moving and aged inventory during the quarter.

While our decision had an adverse impact on margins, we know the actions we are taking with inventory to strike the right balance between an enhanced assortment and her shopping experience are necessary to deliver better top line results and profitability moving forward. Of note, non-clearance selling margins, both in-store and online, were up versus last year. This speaks to the progress we are making in our assortments and provide evidence as we continue to get our inventory better aligned with our customers wants and expectations, we will deliver improved profitability. We ended the quarter with liquidity in excess of \$1.9 billion, and we continue to expect positive free cash flow for fiscal 2018.

Let's turn now to a more detailed review of our Q3 performance. As I mentioned earlier, our comp sales on a shifted basis were down 4.5%. Divisions in categories that outperformed the total company comp for the quarter were Jewelry, Women's Apparel, Men's and soft tone. We are pleased with the continued performance improvement in our Women's Apparel business. While comps were approximately flat on a shifted basis in women's, we saw sequential improvement versus the second quarter on a 2-year stack basis and continue to be pleased with the customer's response as we land new sets in stores and online. In addition, we saw improved gross margin performance in women's versus last year. Categories and brands in Women's Apparel that comped positive for the quarter, both on a shifted and unshifted basis, included dresses, active, our Liz Claiborne brand, our Worthington brand, outerwear and cold-weather accessories.

Lastly, our Junior's business saw double-digit sequential improvement in the third quarter versus the second quarter and was approximately flat on a shifted basis.

Given our renewed focus on women's and its recent performance, we are confident that our initiatives will continue to have a positive impact on this business moving forward. Also, Men's apparel outpaced the company comp with particular strength in big and tall, active and seasonal categories. Our focus on special sizes continues to show results with our Men's big and tall business up nearly 15% this quarter. This customer knows they can count on JCPenney to provide the fit they need and the style they deserve. And we have seen a very strong reaction to our new partnership with Shaq. Conversely, category that underperform the company comp included big ticket areas at home, such as appliances, women's accessories and handbags. And looking at our third quarter top line performance and monthly sales cadence, our quarter started off well in August, which performed better than our original expectations and delivered a positive comp on a shifted basis. However, we experienced softer sales during September and October, which both came in below our sales plan. We did see some positives in October when the weather broke, and we're encouraged by the performance in key categories such as outerwear and cold-weather accessories. Our third quarter comp sales decline was primarily driven by decreases in transactions and average unit retail, offset partially by an increase in units per transaction.

Geographically, the Northeast and Southeast were our better-performing regions, while the Southwest and Gulf Coast were our most challenged regions. Also of note, we did see strong results in our stores that were previously cotenant with Bon-Ton. Following their liquidation, we have seen



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these stores outpace the balance of the chain. We believe this bodes well and speaks to the overall market share opportunity that exists from competitor closings.

As a reminder, starting in the first quarter this year, credit income is now included in total revenues and was previously reported as an offset to SG&A in prior periods. For the third quarter, credit income was \$80 million compared to \$69 million in the third quarter last year, which exceeded our initial expectations. Our credit income this year has improved relative to our expectations at the beginning of the year, which is largely a function of an improvement in the credit customer portfolio. Cost of goods sold for the third quarter was 68.1% of net sales, an increase of 210 basis points compared to the same period last year. The increase is primarily attributable to the clearance markdowns related to our decision to liquidate slower-moving excess inventory during the quarter.

In addition to the inventory liquidation I referenced here, our online margins were pressured as we continue to unwind certain factory ship partnerships related to our previous SKU expansion strategy. We forecast online margins in Q4 to be pressured as well, but significantly less so than the third quarter as we have made strong progress on these factory ship SKU rationalization efforts.

Overall, gross margin improvement remains a major focus for JCPenney. As we mentioned on our last call, we know that with the right actions and rigor surrounding inventory management, we have opportunities to improve our current productivity and terms as well as effectively manage planned receipts, improve gross margin levels and optimize our working capital to increase free cash flow. One direct benefit of better managing our inventory that can provide significant gross margin upside is our ability to restore clearance selling margins back to historical levels. If you look at our accompanying slide deck from our Investor Relations website on Page 7, our year-to-date clearance margins are down approximately 20% versus historic and average results of positive mid-single digits. Of note, and as shown in the chart, we were in a very similar situation on clearance margin at the end of fiscal 2013, and within 2 years, we're back to positive levels.

This current reality is disappointing but also demonstrates a significant opportunity for us to drive meaningful improvements in gross margin. As a reminder, clearance typically represents a low double-digit portion of our total sales mix, meaning a similar improvement to 2015 levels would yield approximately 200 basis points of total company margin upside. This is clearly a huge opportunity for us.

Looking ahead, we believe there are other areas of opportunity that can provide a meaningful benefit to gross margins, including shrinkage results. Improving shrink is a key priority. We are beginning to see some traction on recent technology investments and staffing adjustments. And additionally, we have taken quick action since Jill's arrival to support our stores with enhanced resources around high shrink locations and categories. Similar to clearance selling margins, we are significantly underperforming in shrink levels relative to normalized rates. By delivering shrink results at historic and industry standard levels, we can see significant total company margin upside on an annualized basis. That said, simply by better managing our inventory and shrink, 2 things that are entirely within our control, we can deliver considerable margin and EBITDA upside. In addition to these margin opportunities, we continue to focus on driving sales improvement across higher-margin apparel categories, leveraging our capabilities within our private brand and sourcing operations and further expanding and emphasizing our pricing analytics efforts.

Moving now to expenses. SG&A expenses for the quarter were down \$37 million to \$883 million or 33% of net sales compared to \$920 million or 32.7% of net sales for the same period last year. The reduction in expenses was primarily driven by lower corporate overhead and incentive compensation. As a reminder, given our adoption in the first quarter of the new FASB standards associated with pension accounting, we now include the current service cost component of pension expense and income in SG&A. All other components of net periodic pension cost and income are now recorded in a separate line item below operating income. Service cost does not impact our cash flow and is funded through our pension trust. The pension plan currently remains in an overfunded status, and as a reminder, no cash contributions are expected for the foreseeable future.

Interest expense this quarter was \$78 million. Adjusted net loss was \$164 million or \$0.52 per share for the third quarter this year compared to an adjusted net loss of \$108 million or \$0.35 per share for the third quarter last year. Third quarter adjusted net loss for 2018 and 2017 included the following items: \$19 million or \$0.06 per share benefit this year related to other components of net periodic pension income compared to \$2 million or less than \$0.01 per share benefit last year; \$11 million or \$0.03 per share this year related to restructuring and management transition charges compared to \$52 million or \$0.17 per share last year; \$3 million or \$0.01 per share, both this year and last year, related to the proportional share of net income from the Home Office Land Joint Venture; \$2 million or less than \$0.01 per share related to the tax impact resulting from other comprehensive income allocation compared to \$30 million or \$0.10 per share last year.



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Now let's turn to our capital structure, liquidity position and balance sheet. As expected, we utilized our ABL facility during the third quarter to fund a portion of our seasonal working capital needs and ended the quarter with approximately \$440 million in outstanding borrowings, an increase of approximately \$260 million from the end of the second quarter. As such, our liquidity position at the end of the third quarter was in excess of \$1.9 billion. At our November peak, which will occur in the coming days, we expect to have a total of approximately \$570 million outstanding under our ABL facility and total liquidity of approximately \$1.8 billion. We expect to repay the entire outstanding balance by the end of the year. And as I mentioned earlier, we expect to end the year with a liquidity position well in excess of \$2 billion.

As a reminder, we have very manageable near-term debt maturities with \$50 million of unsecured debt maturing in October of 2019 and \$110 million of unsecured debt maturing in 2020. Cash and cash equivalents at the end of the third quarter were \$168 million. Free cash flow was a use of \$500 million for the first 9 months of the year. Inventory at the end of the third quarter was approximately \$3.2 billion, down \$183 million or 5.4% versus last year. We expect inventory to be down at least 6% at year-end.

During the third quarter, we completed a multiyear extension of our private label and co-branded credit card agreement with Synchrony Bank. The amended and restated agreement with Synchrony provides for improved alignment with respect to the marketing and servicing alliance of the program. In addition, and as previously announced, we will receive onetime payments from Synchrony totaling \$50 million, of which \$30 million will be received in the fourth quarter this fiscal year, and the remaining \$20 million will be received in Q2 next fiscal year.

Lastly, I wanted to discuss our decision surrounding our sales and earnings guidance for the balance of 2018. Given our recent leadership transition and the need to further assess current and go-forward execution of the business, we believe it is appropriate to withdraw our previous 2018 full year earnings guidance. We want to give Jill the appropriate time and flexibility to determine where she wants to take JCPenney long term. As we execute against our holiday strategies and inventory reduction initiatives, we will focus our efforts on executing well this fourth quarter and making the right long-term decisions to create a solid foundation for improvement in 2019. That said, we expect annual comp sales to be down low single digits this year. And as mentioned earlier, we expect positive free cash flow for fiscal 2018.

In closing, we have renewed energy and passion throughout our organization under the leadership of Jill and team. We're identifying the issues and opportunities and developing plans and actions to deliver improvements. Our focus is to put the customer first, get back to the basics of retail and unleash the creativity and capabilities of this great organization.

And with that, I'd like to turn the call back to Jill for a few closing remarks before we open the line for questions. Jill?

Michael Fung - J. C. Penney Company, Inc. - Interim CFO & Interim Executive VP

Thank you, Trent. I spent 30 years in retail, about half of that in turnaround situations and have always watched JCPenney as a competitor. I have immense respect for our company's enduring strengths, strong operations, great quality products, loyal customers and devoted, knowledgeable associates. How we leverage these strengths will be critically important to our future success. I look forward to listening and learning more about JCPenney and understanding the fundamentals the company needs to strengthen and rebuild, along with the transformational strategies we will develop and implement in order to compete in today's fierce retail landscape. If we can act with the customer, act as one team, strength in our retail fundamentals and leverage our enduring strength, we can succeed in any retail environment. Again, we are in the process of developing our strategies, so please hold any of those questions. I look forward to sharing my thoughts and strategies as we progress.

And now we will be happy to take your questions. Operator, we are ready to open the lines.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Paul Trussell with Deutsche Bank.



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

This is Gabby Carbone on for Paul. So we understand you're withdrawing earnings guidance for the year. But how should we be thinking about the P&L in 4Q? Could margin pressure this quarter be similar to 3 quarter? And then any color around quarter-to-date comps? You mentioned you saw some positives in October when the weather broke. So just wondering if that has continued into November.

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

Sure. This is Trent. I'll take that one. So I think from a fourth quarter perspective, as it relates to your question, we do expect some pressure on comp sales line. We do see pressure on gross margin. To answer your question directly, not to the extent we saw in the third quarter from a gross margin decline perspective. Quarter-to-date, this quarter, we're not going to get into a commentary on the quarter-to-date trends for November, but obviously focused on delivering a strong fourth quarter, meeting the customers' expectations around holiday. I think lastly from fourth quarter, on an SG&A perspective, we're probably looking at something relatively flat to LY. So again, some comp pressure, some margin pressure, albeit not to the extent of the third quarter and a flattish SG&A environment is how we see it.

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

That's really helpful. And then just a quick follow-up. So you mentioned that the non-clearance selling margins in both store and online were up versus last year. Could you maybe discuss in some more detail what is driving this?

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

Sure. Look, I think candidly it's the efforts the team has been making in terms of improving the overall assortment. We've seen some better sell-throughs on that product in the early initial sets, so that's obviously been very encouraging. We are seeing those higher-margin categories performing better relative to the previous year and even earlier this year. So it's really, I think, a better job by the teams in terms of buying, focusing and enhancing our apparel categories and some of the higher margin categories that we have across our store. I think it's really what's driving that fundamentally.

Operator

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

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

First, I have a question for Jill. First, welcome to JCPenney. And acknowledging that it is early days for you and the company, I think, has been running inventory heavy for some time. As you've walked the stores, what stands out to you most in terms of what do you think needs to improve, kind of what your first impressions are there? And maybe you could touch on works contents or customer experience, things that are standing out to you most. And then just have a follow-up.

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

Yes. Well, thanks for the question and thanks for the welcome. I appreciate it. As I mentioned, I do see us as being over-sorted, and certainly, we've had high inventory levels. And as I continue to listen and learn and speak with the team while spending considerable time in the stores, I would say that I see the opportunity is pretty much across the board. Our focus will be to develop compelling assortments to appeal to our customers while driving the appropriate terms and profitable sales. As it relates to the merchandise assortment, I'm just beginning to spend a lot of time with the customer and customer data and understanding exactly what to our customer wants and desires for us. As I mentioned, everything I do is



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generally fact based and data supported. And I really need to get more closely connected with the customer who, in the end, is the person who matters most here. So I can't share specifics around merchandise. I think we have great opportunity. We have some great merchandise in the stores. But we need to really spend our time focused on what the customer tells us so we know exactly where to go.

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

Okay, that's helpful. And then as a follow-up, and this is sort of a broader question and maybe it's more of a forward question, but to the extent you guys want to answer it. I know your real estate is presently encumbered. But you still do own a lot of real estate as a company. And it strikes me that maybe JCPenney would be better -- a better operating company with stronger financials if it had a smaller brick-and-mortar sleeve. More the real estate were converted to just to pay down debt and expenses, including interest were further reduced. So I'm just wondering where the board stands on that and maybe a bit of restructuring including the store fleet real estate debt and expense structure would be prudent to think about at this time.

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

Jeff, it's Trent. Yes, I won't speak for the board clearly on this issue. But I think to your point, we've closed roughly 20% of our locations over the last handful of years, including about 140 last year. We're in the process of reviewing the store fleet as we do on an ongoing basis, but specifically at the end of the year each year right now. So that's an ongoing process for us and look forward to, obviously, updating you at the end of this year on our thoughts surrounding that. I think to your point on the debt and so forth, look, those items mature in about 5 years from now. As I mentioned on the call, we have a very manageable runway from a maturity schedule perspective. Do we still feel we have a little too much debt? Yes. Are we over-levered? Look, I think it's more a function of needing to improve the EBITDA. Leverage is also a dictation of the time line, right? So while leverage is a little ahead of where we are, we have an incredibly manageable near-term maturity schedule. We'll continue to think about options and opportunities with respect to real estate and our debt. And we'll continue to have conversations with developers on ideas and options to enhance certain mall locations and improve the customer experience, not only in our stores, but across the malls that we co-tenant in. As I mentioned, we are seeing, as competitors close, some benefits in those co-tenant store locations. Expect that to continue with other competitors. Obviously, kind of facing that near-term certainties. So it's constantly under review and that will continue. But we feel it is very manageable today. But certainly, it's our commitment to continue to look at, consider and review several alternatives as it relates to debt, to real estate. It's, frankly, to the retail footprint as Jill alluded to in her prepared remarks. So we'll, frankly, be looking at everything.

Operator

Our next question comes from Chuck Grom of Gordon Haskett.

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

Welcome, Jill. My question is on the gross margin opportunity. And Trent, I like the slide you gave here on Page 7. Just wondering if you could amplify on the opportunity ahead. If you look at 2013 to 2015, you recovered the big drop when Ron Johnson was there. Just wondering if you think out over the next couple of years, if that time line, say, 2 years to get back to, say, flattish clearance selling margins is realistic.

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

Sure, Chuck. Look, I don't think we want to commit to any time lines today. But certainly, I think the chart is indicative of a meaningful and fairly quick opportunity for us, right? We're seeing, as I mentioned in my prepared remarks, some benefits in the non-clearance selling margins, speaking to the better assortments that we're beginning to set in-store and the benefit from the early days of our inventory reduction initiatives. So I don't want to commit to a time line. I think it is imperative to note that this is really -- right, this is up to us. This is around better merchandising disciplines and better fundamental approach to this business. So it's incredibly doable. As you mentioned, we've done it before. Candidly in 2013, there was a lot more going on, if you will. A lot more things to sort of wrap your arms around and fix than there necessarily are today. So I don't mean for that



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to imply that it will happen sooner than it did last time. Again, don't want to commit to a time line here. But it is clear that there's an opportunity for us to get back. And look, breakeven or just above, frankly, still wouldn't be where we'd like to be or where we have been historically and where generally the industry is at. So it's a huge opportunity there. Clearly, a big opportunity in shrink, which is again a very fundamental part of this business. One thing Jill has made incredibly clear in her early days is we are not going to take those results moving forward. And she has taken very quick and aggressive action to ensure that we are remedying that situation as opposed to just speaking to it. And I think that's very telling to the team that we're going to move prudently but quickly in an effort to obviously restore profitability but also improve the general customer experience in our stores, which will lead to many of those improvements that we expect in the future.

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

Okay. And then for Jill, when you take a step back, what do you think you need to do to improve the overall image of JCPenney? As part of that, I believe your plan would be to get younger. Clearly, transactions have been down for many, many quarters in a row, where obviously an issue here in the third quarter. But just bigger picture, a couple of your competitors are doing a lot to sort of rebrand themselves, if you will. I mean, just curious, it may be early to ask but just wanted to see if you wanted to opine on that.

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

Yes. No, I appreciate it. It is early to ask because, as I mentioned, we are just stepping off on getting our thoughts on the table and developing action plans. I'm not the type that comes in and just tell people what we're going to do. I really value the organization here. And the 100,000 associates that we have, they have great expertise. They're a terrific group. And the one thing I know after being a retailer for 30 years and spending my entire career focused on customer-facing areas and inspiring those to bring it to life is they have a lot of value. Institutional knowledge is really, really important. And so as I mentioned earlier, we're getting very close with customer. I'm getting very close with the associates. And we will do what's right for our customer.

Operator

And our next question comes from Mark Altschwager of Baird.

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

Welcome, Jill. Jill, you mentioned data a few times in your prepared remarks. I'm wondering if you can give us a sense of your initial assessment of JCPenney's data capabilities, both in terms of the operational side of things as well as understanding your customer. And do you believe you have the tools you need today to both understand the challenges and take swift action next year? And then separately, you also talked about a lengthy process. I know it's too early to provide any kind of longer-term strategic outlook. But is this a signal that it's your view that the business may need to take a step back next year before it can return to more profitable growth? And then a quick follow-up for Trent.

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

So the first part, the data, we have over 100 years of customer connection and we have a lot of information about our customer. And we have some terrific associates who spend energy on understanding that customer and sharing it with us. My focus will be to not only understand that what that says but also how we're getting to it and what we do with it. Do we have all the right tools? I'm not sure yet. I'm assessing that and figure out where we need to go forward. But it's really important that we understand our customer analytics and use them to engage with customer. And then from a time standpoint, my experience in stepping into organizations that have had a lot of change, it does take time. And in most cases, things don't improve right away, that sometimes they can take a step back as the organization is getting their footing and determining where they need to go. A lot of times, that includes making shifts in current strategies and putting things in place. And that's what we're focused on doing. Figuring out where we are and where we need to go and what that entails is yet to be seen.



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

And Trent, to follow up on the comp guidance. A low single digit implies a pretty wide range of outcomes for the fourth quarter. So maybe unpack that a bit for us and speak to some of the key product initiatives where you have the most confidence and where you're feeling the most cautious heading into Q4? And maybe address just the trajectory of appliances and beauty. I don't think those were called out in the prepared remarks.

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

Sure, Mark. That's no problem at all. You're certainly right about the wide range of outcomes. Listen, I think from a fourth quarter perspective, we'd be hopeful and expecting that comps probably come in a little better than what we saw here in the third quarter overall. I think that's probably as far as I'll go on Q4 because I think a lot of what Jill has been speaking to, right, is the need to continue to assess the strategies, reconsider some of those approaches. Now when you think about Q4 relative to Q3, there's some pieces we've got in terms of promotional cadence, less difficult comparisons in certain categories. You mentioned beauty. That's one of them. We launched the Fenty brand last third quarter to a tremendous success. You obviously didn't call out that beauty is a category that exceeded the company. It certainly implies it was a little below and that was really driven by that color business up against that comp from last year. So wouldn't expect there's meaningful of a headwind there. I will tell you within that business, fragrances and skincare continued to be outstanding performers for us as we, frankly, get better and a more robust assortment of skincare and really focus our efforts in terms of the fragrances that really matter to our customers. So I think, clearly, still very pleased with that world-class partnership we have with Sephora, have some new initiatives coming in for holiday that we think will help us, obviously, do a better job than we did in the third quarter and certainly are up against some of those launch dynamics from the third quarter. In terms of what we're excited about for holiday, I think one thing certainly that we are continuing to be focused on is the improvement that we are seeing in apparel. I think the team is still quite good about some of the product they've put forward for apparel and for our holiday sets. We've recently launched our new brand Peyton and Parker, which is going to be a very nice family-oriented apparel assortment designed and curated by our wonderful sourcing teams and merchants. I think that's something we're excited about. That's been one of our better businesses of late in the holiday, are some of these family-oriented apparel offerings, so we're excited for that business. I spoke a little bit about competitive opportunities. I think that's certainly an area we expect some benefits in the fourth quarter. We mentioned toys. I believe Jill did in her prepared remarks and some of the expansions that we've got going on there to take advantage of that market share. It's also true in baby. That's an area that we've seen some nice results in of late as we continue to take opportunities from that market share that is available. And again, the Bon-Ton -- co-located stores are previously Bon-Ton co-located stores, excuse me. Those have shown some very nice results here in the third quarter and would expect some continued improvement there. And then lastly, Jewelry has been a business that we've been pleased with. I think the customer continues to respond very nicely to what that group has done from a curation and merchandising perspective around great gifts for the holiday season. So those are some of the things I think we're excited about and focused on. And I think to kind of come back full circle to your original question, we would expect negative comps in the fourth quarter as we assess, but hopefully, something a little bit better than what we saw in the third quarter here.

Operator

Our next question comes from Kimberly Greenberger with Morgan Stanley.

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

Jill, I was very interested in your commentary around rebuilding the merchandising capabilities. I'm wondering if you could just give us your initial assessment of sort of the state of the state, what has happened? And I know that you're still developing all of your strategies for go forward. But maybe you could just tell us what rebuilding merchandising capabilities mean to you. That would be super helpful. And then I just have 2 quick follow-ups for Trent after that.



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

Yes, great. Thanks, Kimberly. We have a terrific group of merchants here. I've had the opportunity in my short tenure to meet with all of the leadership and many of the buyers. And these are professional merchants who know their business. They are drivers and they are in it for the long run to drive their business and create compelling assortment. We also have incredible brands, many that Trent mentioned. But others, they have a long history. They have great equity. Our customers are very devoted to them. And it is that combination of the brands and the people in which are driving those strategies that I'll work with to determine, based on what our customers says, where we want to take those. And so in terms of rebuilding our merchandise capabilities, it's laying out our strategies and understanding truly what drives our customer attitudinally and behaviorally to know exactly how those brands fit within her life today and how we can make a more meaningful and compelling assortment and shopping experience for her.

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

Okay, great. And then Trent, could you just help us understand the accounting behind the Synchrony payment? How will that \$30 million flow through the P&L in Q4? Is it an addition to credit revenue or some sort of offset in SG&A? And then if you could give us the basis under which you will calculate and report fourth quarter comps, that would be super helpful.

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

Sure, Kimberly. So from a credit income perspective or the bonus payments from Synchrony, that will flow through credit income, but it will be a very slight benefit. It is an amortized portion of that over the period of new agreement. So an incredibly minor impact on the P&L in the fourth quarter, but it will be in credit income. There is no offset in SG&A. And then, obviously, the cash will come to us in terms of the full amount of \$30 million here in the fourth quarter. So that's how you look at that. And Kimberly, I'm sorry, the second question you had, excuse me?

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

Is -- yes. What's the basis that you used to calculate comps in Q4? Is it like week for like week? Or are you going to do a fiscal? I'm not sure.

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

Yes. No, no problem. We will provide both. Moving forward, we're going to obviously provide both. But clearly looking at it on a shifted basis is the more appropriate way to really tell how the business is performing. So we will be providing both, Kimberly.

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

Okay, great. So just to clarify on the Synchrony. So is that a 3-year agreement, a 5-year agreement? How long will that \$50 million be amortized over?

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

Yes. It's a -- it is a new 7-year agreement beginning next year.

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

Okay. So you get the cash flow in those 2 quarters that you mentioned, Q4 and Q2. But in fact, the impact on revenue is basically divided over the next 28 quarters, I guess.



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

That's correct, that's correct. Yes, yes. That's right. And listen, I think, clearly, the -- it's nice to have a signing bonus. We're thrilled to have a new agreement with a great partner like Synchrony in place. And I think the biggest driver obviously of credit income moving forward won't be these onetime payments. It will be the team's efforts around continuing to improve penetration, the quality of the portfolio, which we've seen some very nice improvements on here of late. And as you know, we're still in that sort of low 40% range from a penetration perspective. So I think clearly some opportunities continue to move that higher.

Operator

Our next question comes from Matt Boss of JPMorgan.

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

Two questions. First, inventory down mid-single digits this quarter. I guess, do you plan to be in a fully clean inventory position with stores where you want them exiting the fourth quarter and into next year?

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

Hey, Matt, Trent. So as I said, we expect to be down at least 6% at the end of the year. Look, I think we will be most of the way there. But I think as Jill certainly alluded to in her prepared remarks, right, there's still some assessing. They need to happen in certain categories and go-forward strategies and businesses. So I don't know that I would commit to say we will be exactly where we want to be. Clearly, we would have made a tremendous amount of progress against our expectation and goal of being down \$250 million at the end of next fiscal year, be more than halfway there, so to speak. So I think in a much better position. I think with a much clearer assortment. But I don't know that I would commit to saying that we will be exactly where we want to be. I think the inventory reduction initiative will probably last into 2019.

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

Great. And then that leads to the follow-up. So I guess, Trent, maybe if gross margin ends the year in the 32% to 33% range, I guess, should we think of this as the floor or it sounds like maybe more pressure through the front half of '19? I guess, would that be a fair way to think about it?

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

Yes, Matt, I think that is probably fair. As you look at 2019, there could be some early pressure on gross margin relative to what we saw this year where we were, frankly, operating at a little bit higher rate in the first and second quarters than where we ended up here, clearly, in the third quarter. I think from an overall annual perspective, we'd like to think that, yes, this is probably about at the bottom and I think in particular when you think about some of those opportunities I mentioned around clearance and shrink and, frankly, some of the very clear and obvious efforts that Jill and the team have already put into improving, particularly on shrink but also clearly on the inventory side. So I'm not going to be able to give you a perfect answer, but I think the way you're thinking about it is probably appropriate. Could be some pressure early next year. We'd obviously hope that we can start to improve from there. And that, yes, somewhere in this range of outcomes for the full year 2018 is probably a good estimate or data point for what is likely to be the low point for us moving forward.

Operator

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



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

We're curious on some of the key aspects on the digital road map in terms of what you see as the next opportunities with mobile and integrating mobile plus in-store. And related to that question is just over the holiday period and the Black Friday period, you gave us a lot of really helpful details. Are you -- what are your thoughts on what will be most different this year versus last year in terms of how the customer experiences your mobile versus online? And a follow-up was just key -- your key hurdles ahead in Women's Apparel and things we should look for as you continue to make some good changes there.

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

So from a digital standpoint, I would say I'm still very much assessing the organization's capabilities around all things digital. What I do know is that, that is where the customer is today and that's where we need to be or get to as quickly as we can. So I can't give you any detail on that. Just know that I have a huge sense of urgency around that. From a holiday and Black Friday standpoint, I think just like the increased usage in digital and mobile, we've seen it all year round. It's going to peak even more this holiday and we are doing our best to ensure that we are as connected as we possibly can be. Key hurdles ahead in women's. Like I mentioned earlier, we have great brands. We have an opportunity to really connect with our customer once we know exactly what drives her, both attitudinally and behaviorally. Here's what I know. I've been in this business a long time. I'm a student of the fundamentals of retail. I have spent my life energy focused on those. I have a great passion for it. And JCPenney has a place. And since I've taken the helm here, there has been an outpouring of connection points from customers, those I know and those I don't know. And the passion that they have shared with me around the JCPenney brand and how we fit or has fit into her life is something that drives me and our team every single day. And it's those folks that we are completely focused on. And I just look forward to making JCPenney as a really important part of their lives.

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

And then lastly, as you approach thinking about marketing and both broadening appeal and also reengaging as much as you can in the existing customer base, do you have a hypothesis about where you should be in terms of positioning and campaigns and embracing and what's appropriate within the right guardrails of ensuring you stick to a great value, yet increase your appealingness and drive people and conversion into the stores?

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

So as it relates to marketing, we need to really -- as I've mentioned, we need to understand where we can fit within this retail landscape. I know we have a place. We have millions and millions of customers that shop us every single year. And we have people who have been part of their lives for over 100 years. The landscape of marketing has changed dramatically over the last several. And I am still assessing exactly our capabilities, both from a traditional standpoint as well as a digital standpoint. And I assess that with great fervor and drive to understand where we are so that we can begin building the best connection points to engage our customers and drive conversion, and ultimately, focusing on sustained profitable results.

Operator

Our next question comes from Paul Lejuez of Citi.

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

Can you talk about the performance of mall versus off-mall locations during the quarter, where you saw the stronger performance? And I'm curious if there's a big difference between mall and off-mall. And Jill, do you have any initial thoughts about whether JCPenney is better positioned to compete and win in the mall versus off-mall environment? Are you happy with the mix that you have today?



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

So Paul, I'll take the first part. We've been seeing the off-mall outpace the mall stores. It's got a little closer this quarter, but I think generally you are continuing to see off-mall perform a little bit better than the mall locations overall. Not a huge discrepancy or difference this year -- or excuse me, in the third quarter, from a mall versus off-mall. But the off-mall is outperforming slightly.

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

Paul, just jumping on the tail end of your question there on initial thoughts. I don't have a strong point of view, mainly because I haven't been able to get into the data of where we're performing. I don't think it's an either/or. I think it has to do with where each store is located and what the key characteristics are of each of those stores. So as we have time to assess that and develop our fleet strategy, we'll be making decisions either based on facts and determining what we can do to grow our strong stores and what we need to do in stores that may be aren't performing as well as we like them to.

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

Yes. And Paul, if I would, I'll just add one more thing here, just to give a little more context. As I mentioned, the results were pretty even, frankly, this quarter in terms of mall and off-mall. Interestingly though, our best-performing locations were mall-based locations. Now obviously, that's a subset of the overall mall group that I'm speaking to. But I think to Jill's point, we've got to be able to do both. We are a mall-based retailer. We have to find ways to win in the mall. Clearly, some of our competitors are demonstrating solid results in the mall. And we do see that certain mall locations are, frankly, outperforming off-mall locations. So I think Jill said it well. We've got to be able to do both and just wanted to add that extra color here.

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

Okay. And then Trent, I'm sorry if I missed it, but did you talk about store performance specifically versus e-comm during the quarter? Any metrics you can share there on digital versus brick-and-mortar?

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

Sure. No, I didn't speak specifically to it, Paul. We did see a little bit better performance in our brick-and-mortar business relative to dot-com. Yes, we've seen the stores perform a little better. I think as we alluded to on the call and discussed last quarter as well, right, I think the team that has inherited the dot-com business this year had a lot of work to do to clean up some of the initiatives, processes, underpinnings of the site, and I think they've gotten off to a nice start here over the last couple of quarters, beginning to see some -- certainly some improvement there. But stores did outperform dot-com for us this quarter.

Operator

And our last questioner will be from Erinn Murphy with Piper Jaffray.

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

Jill, welcome. I just have 2 questions. I think, Trent, probably you can handle just on the stores that overlapped with Bon-Ton. Were there any categories within your store that you saw the biggest lift in? And then my second question was just overall the athletic pad. I think you've called it out favorably, both with men's and women's. Just curious, how big does athletic represent today in your store? And if you think about the longer-term opportunity, where do you see that kind of trending to over time?



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

You bet, Erinn. That's no problem at all. So I think from a Bon-Ton perspective, it was really pretty universal. I would say some of the more branded assortments in apparel were probably some of the bright spots. Clearly, they had a fairly branded business. We obviously carry some of those key national brands as well. But it was fairly across the board candidly. But certainly saw some bright spots in that branded apparel product. And so that was obviously incredibly encouraging for us. And then, Erinn, I'm sorry, I forgot your second question already.

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

Athletic.

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

Just on athletic. You talked about it favorably in both.

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

Athletic, thank you. Thank you, Jill. Yes. It's been great. It has been great. It's about 10% of our overall fleet now. It's maybe slightly above that. Obviously, a little bit more of that from a pure apparel perspective. But we're behind still there. We're underpenetrated relative to our peer set and I think relative to what the customer would like to see. And so I think there's continued opportunity there. Each time we add newness to that assortment, whether it's continue to expand our great relationship with Nike, enhance our exertion offering, roll out an enhanced presentation and assortment in Adidas or even more recently some of the fanatic shops that we've landed in our store, the customer is clearly voting for active. That, no doubt, continued this quarter. And I think we've got some nice runway ahead of us. And I'd say the merchandise teams have clearly been getting after that opportunity in a big way and I think there's still a lot more market share out there for us to go after.

Operator

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

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