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JCP - Q4 2017 J C Penney Company Inc Earnings Call

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OVERVIEW:

Co. reported 4Q17 adjusted EPS of \$0.57. Expects 2018 adjusted EPS to be \$0.05-0.25.



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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q4 2017 JCPenney Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

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

Trent Kruse

Okay. Thank you, Glenda, 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 March 2, 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 the slides, these slides are meant to facilitate your review of the company's results and to be used as a reference document following the call.



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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 question.

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

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

Thank you, Trent. Good morning, everyone. First, I'm encouraged by our results for the fourth quarter in 2017, and I'm pleased that through the hard work and dedication of the JCPenney team, we delivered our second consecutive year of positive adjusted earnings.

For fiscal 2017, we delivered positive sales comps and improved adjusted earnings per share by 175% to \$0.22 per share. We also reduced our debt outstanding by approximately \$600 million and generated over \$200 million of free cash flow.

For Q4, we delivered positive comp sales of 2.6% and improved our gross margin rate by 50- basis points. Our sales, gross margin and continued commitment to expense controls helped contribute to our fourth quarter adjusted EPS results of \$0.57 for the quarter.

Earlier today, we announced steps to reduce corporate bureaucracy, flatten organizational structures and take out cost. These decisions are always difficult, but necessary to speed up decision-making and make us a more efficient company.

As we bring increased value to our customers, maintaining a culture of intense expense reduction is essential. I'd like to congratulate Joe McFarland, Therace Risch, Jodie Johnson and James Starke on their new leadership roles.

In addition, I'd like to thank our over 100,000 associates around the company for their hard work and, more importantly, for their commitment to JCPenney.

Now let me discuss a few highlights from the fourth quarter. Number one, continued strength in our beauty segment, led by Sephora, Fine Jewelry and our Salon business. Number two, great performance on our Home refresh initiatives. Number three, significant growth in our omnichannel business. And finally, the successful launch of new categories for the holiday season such as toys, TVs and other giftable items.

For the quarter, merchandising divisions that outperformed the company comp average were Fine Jewelry, Home, Sephora, Footwear and Handbags and Salon. And as we mentioned before, our home division is key to our strategic decision to take market share in appliances, Mattress, Furniture and other home refresh categories. Due to the dynamics of mall-based competition in this space, we see a tremendous opportunity to grow sales in Home. And for the quarter, we delivered sales growth of over 30% in Appliances, positive comps of nearly 60% in Mattress and positive comps of almost 40% in Furniture. These results reflect that our strategic plan to invest in Home is working, and the customers are responding to our new product offerings.

Although our Women's, kid's and Men's apparel categories underperformed the company comp for the quarter, the ongoing improvements in these 3 apparel divisions contributed significantly to our 50- basis points of margin improvement in the fourth quarter.

While we're encouraged by overall progress we're making as a company, we're fully aware that our work is not complete.

I'll now hand the call over to Jeff to discuss in more detail our Q4 and 2017 financial results as well as outline our guidance for 2018. I'll come back and close our prepared remarks with a preview of some of the key sales driving initiatives in 2018 and the spring season.

Jeff?



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Jeffrey A. Davis - J. C. Penney Company, Inc. - EVP and CFO

Thank you, and good morning, everyone. We are pleased with our balanced top and bottom line results for the fourth quarter and look forward to building on this momentum in 2018.

In just a moment, I will review fourth quarter and full year results in more detail and provide an overview of our balance sheet, cash flow and liquidity position. I'll then close with our 2018 full year financial guidance before handing it back over to Marvin.

Now let's turn to fourth quarter and fiscal 2017 financial results. For the fourth quarter, total net sales increased 1.8% versus last year, while comp sales increased 2.6%. The comp sales improvement was led by an increase in average unit retail, units per transaction and positive traffic.

Geographically, the Gulf Coast and South East were our best-performing regions, while the West Coast was our most challenged region. As expected, we experienced a soft January, as we entered the period with less clearance inventory and executed several pricing and marketing strategy tests.

Comp sales were slightly positive for the fiscal year, while total net sales declined 30- basis points. The spread between total net sales and comp sales was primarily due to store closures, partially offset by an increase in sales for the 53rd week.

Cost of goods sold for the fourth quarter was 66.4% of sales, a decrease of 50- basis point compared to the same period last year. This improvement was primarily driven by decreased promotional activity resulting from better inventory positions, partially offset by continued growth in our online and major Appliance businesses and higher shrink rates.

Additionally, fourth quarter selling margins were positively impacted by our ongoing margin initiatives and improving the profitability of our private label through design, sourcing and speed-to-market initiatives.

For fiscal 2017, cost of goods sold was 65.4% of sales, an increase of 110- basis points versus fiscal 2016. This increase was predominantly driven by significant growth in our major Appliance and online businesses and higher shrink rates as well as the liquidation of closing store inventory in Q2 and the actions to liquidate slow-moving inventory in Q3. We firmly believe our decision to quickly liquidate inventory in the third quarter was the proper course of action to position us for the holiday selling season and to transition into fiscal 2018.

Moving now to expenses. SG&A expenses for the quarter were \$943 million or 23.4% of sales, which is flat as a rate of sales compared to the same period last year. Reductions primarily in store controllable cost and marketing were partially offset by lower credit income and higher incentive compensation.

In the fourth quarter, we completed the sale of a leasehold interest for a net sales price of approximately \$50 million. Approximately \$20 million of the net sales price is recorded as a reduction to SG&A expenses in fiscal 2017. The remaining \$30 million will be recorded as a reduction of SG&A expenses in fiscal 2018. For the full year, SG&A expenses were down \$70 million to \$3.5 billion or 27.7% of sales, representing a 50- basis points of leverage versus last year.

During the fourth quarter, we recorded a \$25 million noncash, mark-to-market charge related to our supplemental retirement plans. During 2017, the primary pension plan funded status improved to 102%, mainly due to the strong performance in planned assets, which generated significant returns for the year. Our pension plan continues to be in a well-funded position, and we do not expect to make cash contributions for the foreseeable future.

The Tax Reform Act that became effective in December favorably impacted our fourth quarter income tax provision by approximately \$75 million. This favorable noncash impact was primarily attributable to revaluing our net deferred tax liabilities to a lower combined federal and state tax rate of 26%. It is important to note that the 80% taxable income limitation imposed by the Tax Reform Act will not limit the usage of our existing NOL. Further, we do not anticipate paying cash income taxes in the immediate future given our size of NOL carryforward for both federal and state.

Now let's turn to capital structure, liquidity position and our balance sheet. During the fourth quarter, we opportunistically repurchased \$40 million of our 2020 notes in the open market at prices below par, reducing the total outstanding balance to \$360 million. This effort, combined with the



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actions we took throughout the year, reduced outstanding debt by over \$600 million in fiscal 2017. In addition to our fiscal 2017 debt reduction efforts, we recently retired, at maturity, \$190 million of notes due February 5, 2018.

As I discussed last call, our capital allocation priority is to deleverage the balance sheet through debt retirement at maturity or proactive refinancing. While we remain confident we can fund maturities from free cash flow, we will continue to monitor and evaluate refinancing alternatives on an opportunistic basis.

As expected, we continue to draw down against our ABL facility in the fourth quarter to fund a portion of our seasonal working capital needs. At our November peak, we had a total of \$340 million outstanding under this facility. And by the end of November, the entire outstanding balance was repaid, and we ended the fiscal year with a 0 outstanding balance. As such, our liquidity position at the end of the year exceeded \$2.3 billion.

Cash and cash equivalents at the end of the year were \$458 million, a reduction of \$429 million versus last year. As I mentioned earlier, we utilized approximately \$600 million in available cash throughout fiscal 2017 to reduce outstanding debt levels. In addition, we invested \$375 million in capital expenditures, net of landlord allowances.

For fiscal 2017, we generated \$213 million of free cash flow, an increase of \$210 million compared to last year.

Inventory at the end of the year was approximately \$2.8 billion, down 3.2% versus last year. Inventory is well positioned heading into 2018, and our teams remain committed to effectively manage inventory levels without sacrificing customer availability.

Merchandise accounts payable was \$973 million, down \$4 million versus the end of last year. The reduction was primarily due to our reduced inventory position.

Turning now to fiscal 2018 guidance. In fiscal 2018, JCPenney will implement new FASB revenue recognition standards and changes to pension accounting when we report first quarter results in May. We do not expect the impact of these accounting changes to have a material impact on our 2018 full year earnings results. To simplify our discussion today, our 2018 financial guidance reflects our current accounting methodology.

Earlier this morning, we issued the following guidance for full year fiscal 2018. Comp store sales are expected to be in the range of flat to up 2%, and adjusted earnings per share are expected to be in the range of \$0.05 to \$0.25 per share.

In a moment, I'll provide more detail on other key business metrics, but before I begin, I'd like to remind you of a few items from fiscal 2017. First, we closed 141 stores in fiscal 2017, most of which were closed -- in the closing process in late -- excuse me, late in the second quarter. For fiscal 2018, we expect to close approximately 7 stores and the majority of these will be closed in the second quarter.

The sales generated from the 53rd week and 2017 store closures will have a significant impact on total net sales in fiscal 2018. As such, we expect total net sales will be approximately 430- basis point lower in comp sales in fiscal 2018. This spread will be approximately 560- basis points in the first quarter.

Next, we recorded approximately \$120 million in net real estate gains in fiscal 2017, majority of which was realized from the sale of our Buena Park distribution facility in the first quarter of last year. While we expect to monetize additional assets in fiscal 2018, including the sale of our Milwaukee, Wisconsin distribution facility, we don't expect to generate the same level of net gains in 2018 as we did in 2017. As such, we expect net real estate gains to be in the range of approximately \$50 million to \$60 million in fiscal 2018. Having said that, when you exclude the gains from asset sales, earnings per share is expected to grow in 2018.

Moving now to other key financial metrics and expectations for fiscal 2018. Comp sales in the first quarter are expected to be at the upper end of our annual guidance range. Full year cost of goods sold as a percent of sales is expected to be down moderately versus 2017. However, in the first quarter, we expect a 40- to 60- basis point increase in our cost of goods sold, as we should see our largest cost of goods sold reductions in the second and third quarter. SG&A dollars are expected to be down versus 2017.



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Depreciation and amortization is expected to be approximately \$550 million. Net interest expense is expected to be approximately \$300 million. Primary pension expense is expected to be a credit of approximately \$45 million. Credit income is expected to be approximately \$45 million less than in 2017. Income tax expense is expected to be approximately \$17 million. Adjusted EBITDA, at the midpoint of our guidance, is expected to be approximately \$915 million. Capital expenditures, net of landlord allowances, are expected to be approximately \$375 million. Free cash flow is expected to be between \$200 million and \$300 million. And inventory is expected to be down mid-single digit at year-end.

In closing, we are focused in 2018 on increasing inventory turns to increase free cash flow, improving 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 will continue to remain focused on executing our 3-part strategic framework of private brands, omnichannel and increasing revenue per customer. Let me discuss some of the key initiatives that give us confidence in achieving our 2018 financial objectives.

First, let's focus on beauty, as one of the key components of our strategy, will always be our best-in-class partnership with Sephora. After opening 70 new Sephora locations in 2017, we currently operate 641 Sephora inside JCPenney shops, which represents Sephora shops in nearly 75% of our stores. We'll continue to build on this best-in-class partnership by opening approximately 30 locations in 2018, bringing our total to approximately 670 Sephora shops.

We remain very pleased with our launch of Fenty Beauty by Rihanna in September, which is exclusive to both Sephora and Sephora inside JCPenney. We believe this new launch will continue to drive significant incremental sales and foot traffic to our Sephora inside JCPenney shops throughout 2018.

We're also excited about a series of new launches and brand expansions we have planned for Sephora in 2018, and I'll keep you updated on the success and timing of these launches on future calls.

Another key component of our beauty strategy is our Salon business, and following a great year of positive sales growth in our salons, we are continuing our rebranding efforts to Salon by InStyle.

In 2018, we plan to rebrand and remodel another 100 salons to Salon by InStyle. When we rebrand a salon, the sales performance in these sales locations improve, on average, by 400- basis points. And as a reminder, our Salon customers visit a store to shop twice as often as a non-Salon customer. Enhancing the client experience is important in this space because this is an excellent customer acquisition tool.

Additionally, Fine Jewelry is a key component of our beauty strategy. Our jewelry business comped positively in every quarter in 2017, including a double-digit comp in the fourth quarter. Our jewelry business is bringing in a newer and younger customer to JCPenney, and we have aggressive plans for 2018. JCPenney is the only retailer that can offer our customers a total beauty solution, combining Sephora, Salon and Fine Jewelry under the same roof. This unique beauty experience cannot be replicated online and magnify the importance and relevance of our physical stores.

Next, our Home refresh initiatives continue to provide strong results. We delivered double-digit positive sales in our Home division every quarter in 2017 and expect to continue the momentum into 2018. As I mentioned earlier, we have an unprecedented growth opportunity in this area. Over 70% of our customers are homeowners, and we have a large competitor in this space donating market share. We've identified over 300 malls, where we will aggressively pursue this unprecedented sales opportunity in 2018. We've developed a merchandising assortment, which includes appliances, mattress, furniture, simple home installs and workwear that will generate market share gains, as struggling mall competitors continue to close. With billions of dollars of potential market share up for grabs in the near future, our strategy will be surgical, yet aggressive, and we will not sit on the sidelines and allow all of these sales dollars to go to other retailers.



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Third, we continue to enhance and strategically adjust our apparel offerings to better align with customer preferences. A strategic priority in 2018 will be our continued focus on fixing the Women's Apparel business, particularly Activewear, dresses, contemporary and casual sportswear. These categories offer JCPenney the greatest opportunity for growth in Women's. And I'm pleased to report that our casual and contemporary categories delivered strong sales growth in the fourth quarter as our customers responded very favorably to the updated assortment and sales floor layout. Each monthly set we delivered in the fourth quarter in Women's in the fourth quarter and in February produced positive comps and dramatically improved sell-through rates versus the prior trends. In addition, the implementation of our speed initiative provided enhanced newness for our customers.

The lessons learned in fall and Q4 will be the foundation of our Women's Apparel strategy for 2018. Specifically, we are aggressively implementing our new strategy to improve speed and offer great fashion at a value across several categories.

And as I mentioned, Activewear will be a big part of our growth strategy in Women's, and we are admittedly behind in our assortment, which offers JCPenney an opportunity for strong growth in 2018. Moving into this year, we will continue to significantly expand the breadth of our Adidas assortment, increase the number of stores carrying the brand and meaningfully upgrade the in-store experience with Adidas shops. Additionally, we will enhance our Nike assortment and experience across the chain. Beyond these great brands, we are also launching new brands in this category such as Puma, Champion and Copper Fit.

Across all apparel categories, special sizes remain a key focus, as we leverage our industry-leading big and tall and kiosk plus businesses, as we continue to deliver an improved assortment in women's sizes as well.

And lastly, we continue to be committed to becoming a world-class omnichannel retailer. In my 2 years as a CEO, we've been committed to transforming JCPenney from a company focused primarily on the brick-and-mortar business to a true omnichannel retailer. And this transition is evidenced by the following. In 2017, we increased our online SKU count by 50% with plans to add an additional 600,000 SKUs in 2018.

In addition, in 2017, our team transformed our mobile app from 1.5 star-rated app with minimal reviews to an over 4.5 star-rated app with over 150,000 reviews and counting. And in 2018, we'll continue to invest and enhance our mobile experience.

We're also pleased that, today, roughly 80% of the store's existing inventory is eligible for free same-day pickup. 100% of our brick-and-mortar store network is now being utilized to fulfill online orders, and over 40% of our dot.com orders were fulfilled from a brick-and-mortar store.

Although change is never easy, we believe the changes we announced today through our omnichannel and IT teams will streamline the organization and accelerate decision-making. Omnichannel will continue to be one of our top priorities in 2018 and into the future.

And in closing, retail in the U.S. is a multi-trillion industry, and we believe there can be multiple winners. Those retailers who could offer their customers the best in-store and online choices, while eliminating friction, will be the winners. At JCPenney, we clearly identified our customer segment, developed a consistent retail strategy and improved our balance sheet, so we plan to be one of the winners. We know we have additional work to do, but we're encouraged by our progress as a company. And consequently, in 2018, we're focused on 2 critical factors: to operate the business for growth and deliver profitable earnings.

And with that, Glenda, we'll open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Bob Drbul from Guggenheim.



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

I guess, just the first question that I have is on the Women's business, generally, in terms of the ability to turn the business, as you look through this year, can you just comment on the biggest drivers that you see throughout '18?

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

Yes, Bob. It's really goes to the prepared comments. I mean, we're very excited by the Activewear potential. As I've mentioned, we're a little bit behind, and we admit that, but that gives us a tremendous opportunity for growth. We also are really pleased that all of the new sets that we implemented in the fourth quarter starting, really, in December and also going into January and February, all of those sets produced significant positive comps over previous trends, and we're going to be setting the entire company -- Women's Apparel Spring set -- within the next week or so. So every indication that we've seen has been very, very positive. In addition to that, Women's Apparel is a huge component of our online business. And as we continue to add SKUs and we continue to create the same list, store and digital interface, the business is performing well, and I can't end my conversation, without talking about the power of the plus size brand. We did not have Liz Claiborne as a plus size brand for, really, the first 2 quarters of last year, so we're going to have non-comp performance with the introduction of Liz later last year, and that business is doing exceptionally well. So all of those things leads us to believe that we're going to have a much-improved business, and the trends reflect that.

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

Great. Just one more, if I could. On the big ticket items, can you talk about your performance there? And I guess, specifically, will you be expanding Mattresses beyond the 500 stores? Can you talk a bit about that category and your participation there?

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

We've been exceptionally pleased with, not only Mattress, but the entire Home initiatives. As I mentioned, we grew Appliances in the fourth quarter by 30%. The Mattress business and the Furniture businesses were exceptionally strong. We're in the process of evaluating it. As I've mentioned, we chose 300 specific stores because of their proximity to our competition to really lean into this home strategy and test the ability to take aggressive market share. We've been exceptionally pleased with the progress, and we see no real slowdown. What's also interesting is that as we perform in these categories, suppliers are coming to us, wanting to be a part of the assortment, which is something that we're pleased with.

Operator

And our next question comes from the line of Erinn Murphy from Piper Jaffray.

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

I guess, I had a couple of questions. Marvin, first for you. You guys talked about a bit of a slowdown in January, but it was, really, there was a number of planned tests around pricing and marketing strategies. Can you just talk a little bit more about what you're learning with those initiatives?

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

Yes. So we're actually -- when we look at January, we actually beat our expectations financially for the month. And as you mentioned, I mean, we used the month for a couple of things. We wanted to pilot a couple of different marketing and pricing initiatives just to gain learnings going into 2018. And from that, we made a few adjustments. And you'll see us launching a new marketing campaign within the next couple of weeks. And as you know, in this environment, understanding your effective marketing channel is something that, I think, all retailers is continuing to perfect. But I think the most important thing about January is that we didn't see the month as, really, a slowdown because as we look at the month of February,



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we're very pleased with the positive February sales trend. Thus, we don't see a sales deceleration coming out of the holiday season. January was strategic, and we feel good about it. And we think the momentum we're carrying into 2018 is something that we feel good about.

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

Okay. And you're kind of feeding me my next question, but you referenced Q1 at the upper end of the flat to 2% to guide for the year, and you've just commented February as a positive. Should we assume it at that range as well?

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

What I will say to you is that we think that February is actually performing better than that trend. And as I said, we don't see it as a slowdown coming out of the holiday. We see the trend continuing from what we saw during that period when we've taken the upper end of that.

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

Okay. And then my last question is just on the beauty business. You guys have done a nice job, and I know the benefit of Fenty has been pretty strong broadly across the industry. It's driving traffic to your store. I'm curious how you are capitalizing on any of that positive footfall that you're seeing that, that brand is driving. Can you capture in other categories around -- excluding just the beauty business overall?

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

Well, that's really one of the key components of having Sephora shops inside of our stores. The thing that Fenty was able to do for us, it really appealed to a very multicultural customer. And so our ability to really address the needs, to attract that customer is significant. And as that customer was able to come in and we're able to refresh and modernize our Women's Apparel set, we saw a crossover from that customer going in to areas like Activewear, going into areas like denim and going into area like dresses and casual and contemporary. As I mentioned, those were our best-performing Women's categories, and we have to believe that there's a tie into that younger customer, really, being exposed to some of the styles and designs that they didn't even realize that we had. And so we have to build on that. And as I mentioned, we have some really exciting launches planned in Sephora throughout 2018. And we're going to try to connect that customer to the new reinvigorated set in Women's, and we think that is an ongoing trend that we're going to be very excited about.

Operator

And our next question comes from the line of Matthew Boss from JPMorgan.

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

So the midpoint of your comp guide for this year is up roughly 1% versus last year's performance of flat. I know there was some choppiness in the first quarter and in the third quarter as well. I guess, to drive the 100- basis points acceleration on a full year basis, should we plan on increased comp contribution from Appliances? Or is it mostly driven by apparel? Just trying to look at those 2 buckets and understand that 100- basis point improvement this year versus last year. Help us to think about it.

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

So Matt, I'll give you 2 perspectives. So the first perspective is one of the first conversations that I have with Jeff Davis when he arrived as CFO is the need for us to do a much better job of forecasting and planning. So our guidance for 2018 is conservative because we want to get into a habit and a philosophy of under-promising and over-delivering. So we actually believe that our guidance is achievable. So I will start with that as a



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backdrop. And then to answer your question specifically, as we look at sales growth for 2018, we look at it in a couple of different categories. So we start with beauty. As I mentioned, we're going to open 30 new Sephora locations, and we're going to have 100 salons remodel. And I noted in my prepared comments that when we update a salon to Salon by InStyle, the sales on average increases 400- basis points. In addition to that, we are behind in our Activewear set. We admit that, but it gives us a terrific opportunity to have accelerated growth in 2018. So we are investing in this category and expanding Adidas and Nike in Women's and adding Puma and Champion as well as Copper Fit, which has become a really nice niche brand. And our brand in Xersion, our private brand, is performing exceptionally well. So we're still playing catch-up. We think we have really good opportunity. In addition to that, Home is going to continue to play huge dividends. We have 100 non-comp Appliance showrooms for the first half that's going to be tremendously beneficial to us. And we have 300 non-comp Mattress showrooms for, really, the first half. And we also added Frigidaire to the assortment that's going to be non-comp for the majority of the first half of the year. So those are some of the things in Home that we are looking at as potential growth categories. And in addition, I mean, we're going to have non-comp performance in toys. As the competitive set in toys continues to shrink, we have more and more suppliers wanting to add to our assortments, so we are excited about that. And apparel is significant because we had a dismal performance in kid's and Women's Apparel in the first half of 2017. And so we see tremendous upside in both of those businesses, and we are literally resetting every store in the company with our new kid set that should be done within the next week or so. And we, as I mentioned, will be setting our spring women's set here in the next week. So apparel upside is going to be significant, and I couldn't end without mentioning dot.com. It's a huge growth for us. it was a significant benefit to our comp sales growth, and we think that will continue. So all of those things give us confidence that we can hit our guidance and, hopefully, perform at a level that will be to our satisfaction.

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

Great. And then just to follow up, on the gross margin, to break down the moderate improvement this year, I guess, what are the drivers you see offsetting the drag from lower margin Appliances? And then just one confirmation. On the SG&A dollars down, is that inclusive of the \$45 million lower credit income? Or are those separate discussions in line items now?

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

Yes. So Matthew, I'm going to take the first question regarding gross margin. One of the things that we were actually very proud to see is that our private brands continue to improve with respect to our margins. We've been able to use our speed calendar to help us get product to the marketplace at a lower cost as well as allowing our merchants to make decisions closer to the time that the merchandise has to be on the floor set. So we're getting that better and have the opportunity to adjust inventory levels and reduce markdowns as that product is sold through at a much higher rate. In addition, we're continuing to use our pricing analytics to give us better indications of where we can harvest margin versus driving sales in different points of the year. As it relates to the SG&A, so the SG&A, the guidance that we gave today is under our current methodology. So the \$45 million of additional -- or lower credit would be in our SG&A. However, as we think about our SG&A reductions, we continue to look for ways to increase productivity in our stores and our supply chain. And we believe that we have ample opportunity to do so. I'll just leave it at that.

Operator

And our next question comes from the line of Jeff Van Sinderen from B. Riley FBR.

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

I wonder if you could speak a little bit more -- I know you've got the changes in your leadership team, but if you can speak a little bit more about the initiatives you have planned around omnichannel, digital, e-commerce this year. That segment seems to be going nicely for you, and, I guess, the time frame around some of those initiatives. And then on Women's, I just was wondering, a lot of discussion there about some of the things you're working on. Just wondering what's your best guess on when you think Women's as an overall segment in apparel can be positive comp. And then I have a follow-up.



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

Jeff, I'll answer your last question first. I mean, we expect to see a positive comp in the Women's in the first quarter. We are excited about all of the new sets and the performance of those sets. And as I mentioned, we have the full spring set for the chain happening within the next week or so. So we have every expectation that, in Q1, we will see the Women's Apparel business turn positive. And we also have the same expectation for the kid's apparel business. And again, this is based on pilot's tests, a lot of customer surveys and focus groups, but also the great response that we've been able to measure and see from the things that we were able to do in the latter part of the fourth quarter. Relative to omnichannel, as I mentioned, we're very pleased with the overall performance of omnichannel. And what we're going to do is kind of continue to build on the successes from last year. Specifically, we're going to be adding approximately another 600,000 SKUs on top of a 50% growth last year. That's important because it gives us the ability to extend the assortment. In addition to that, we know that our traffic is transitioning to mobile. And so as I mentioned, we had 1.5 star-rated mobile app that's now been transformed to a 4.5 star-rated app -- actually, it's higher than that with over 150,000 reviews and counting, so we're going to continue to invest in the mobile experience. We also understand that the power of retail is going to be how do you connect digital in the physical stores in a most effective way. And we are very pleased that we could say that roughly 40% of online orders are fulfilled from a store, which gives us the ability to drive traffic in those stores. And as a really interesting point, almost 1/3 of the customers that go to a store to pick up something that they ordered online will buy an additional item of roughly \$50. That's significant because traffic is important. And so the combination of all those things really, really matter, but it's more about increasing the efficiency. We do a lot of AV testing on pricing and product placement. And we do a lot of learnings gained last year from how we message to our customers, both digitally and socially. So all of those things give us confidence that we are going to continue to see growth in the omni space.

Trent Kruse

Jeff, this is Trent. I would just add one thing to what Marvin said on the omnichannel piece. Some of the organizational announcements we made this morning include additional resources in the store or redirected, I should say, resources in the store to even improve on the experience for giving us people come to the store and sort leverage off of the results we're already getting there. So I think that will only improve the customer experience in terms of the sort of brick-and-mortar and omnichannel seamless interaction.

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

Okay. That's helpful. And then just a quick followup on shrink. Just wondering if there's any change you're seeing there. I think you said it was still up year-over-year. Just wondering, I guess, how you feel like you're getting your arms around that.

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

Yes. Look, we feel like that we have gotten our arms around it. Shrink will not be material in Q1 because, as you know, we take inventories later in the start of the year. So we expect to see a benefit to margin with our shrink reduction, really, starting in Q2 and for the balance of the year. Because we have fewer inventories, we're not going to see that benefit in Q1. But we feel like we have gotten our arms around it, and we feel confident that, that number is going to come down versus last year.

Operator

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

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

I wanted to follow up on the gross margin guidance being up only moderately. Given the pretty aggressive clearance actions that you're lapping in 2Q and 3Q, it seems like it should be a little bit better for the year. And so I was just hoping you would go through some of the puts and takes



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there, understanding, obviously, the private brand positives that you spoke about. What are the headwinds? And are there opportunities for upside to that line item?

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

So Lorraine, this is Marvin. I'll take that first part and then I'll hand it over to Jeff. And I'll just restate my philosophy from the beginning. We want to under-promise and over-deliver. So we are appropriately conservative with all of our financial guidance because we are still in the last stages of this turnaround. But the short answer to your question is we believe that we will see margin improvement in 2018. And if you -- as I know you are very well versed in the retail world out of there, there's not a lot of retailers that are proclaiming margin improvement year-over-year. I mean, we're pleased with our 50- basis points of improvement this past quarter and we think that is a trend that we will continue to build on. So philosophically, we are appropriately conservative for the reasons I've noted up front. I'll now hand it to Jeff and let him give you more specifics on what we see for 2018.

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

Yes, Lorraine. As I mentioned in the prepared comments, for the year, we would expect our gross margin to expand. For the first quarter, though, we are expecting it to actually be down. And the primary reason for that is that last year, the first quarter of last year was our strongest quarter in margin rate. And we will continue to have -- as we continue to expand Appliances, where we had these 100 showrooms that are non-comp, as well as a further penetration in dot-com, that will provide some pressure against last year's higher margin rate. And last but not least, last year, in the first quarter, we had some inventory residue that we carried out of Q1 into Q2, which meant that we did not take as a deep a markdown in Q1. And therefore, as you recall, the actions we had to take in Q2 and then ultimately in Q3 to accelerate some of those clearance items to make room for our Women's Apparel, so all of that has put a little bit of more pressure on Q1. And we believe that when we get to Q2 and Q3, you'll see that margin expansion that Marvin was mentioning.

Operator

And our next question comes from the line of Mark Altschwager from Robert Baird.

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

Clearly, a big market share opportunity out there. Was hoping you could talk a bit about your performance over the holiday in malls where you've had some competitor exits and how that compared to the company average. And along those lines, you're at a 2% comp for the year. How much do you think will be able to come from share gains in those 300 malls that you mentioned?

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

The stores that were in closest proximity to competitor closings outperformed the company average. And so we're pleased with that, and it's primarily because of specific strategic initiatives that I've mentioned in my prepared comments. We see a tremendous and an unprecedented market share opportunity in some of these categories. And it's one of the reasons why we made the capital investments in categories like 600 Appliance showrooms and over 500 Mattress showrooms and our partnership with Ashley Furniture and some of the other initiatives that we're embarking on. But we also see market share opportunity in apparel. I mean, there is over a \$9 billion category overlap in the malls that we occupy with retailers that are in distress, and we see that as an opportunity for us to get a greater share of that. The consumers are not going to stop shopping just because stores closed. And we have quite a few malls that are reasonably capitalized, meaning that if an anchor closes, they have the wherewithal to redevelop that space. You have some malls -- but we think that number is 50 or less -- that probably will not have the ability to capitalize. And we understand where those locations are. But we also see the tremendous upside benefit that if we continue to fine tune our strategic assortment in these locations that we can continue to see that growth. And we hadn't put a specific pencil to what we think that will be



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in '18 because it's difficult to predict when a competitor will close up shop, but we're prepared. And we have a good track record of getting our fair share of the dollars when that happens.

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

And then just a quick follow-up on the credit side. Was hoping you could dig into the credit income guidance a bit more. And where did you finish fiscal 2017 in credit penetration? And what further opportunity do you see to expand that with the bigger ticket Home categories?

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

Mark, I'll let Jeff give you some thoughts on that question.

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

Very good. Yes, first of all, we are very pleased to see that our penetration in credit for the fourth quarter was up 70- basis points. And for the year, it was up 30. We've ended the year at about a 40% penetration, which is, once again, at a level that we believe we still have opportunity to grow, as we continue to work with some of our most important customers that have the credit card. As it relates to the credit income pressure that we're seeing, we're still seeing net credit losses coming off of what was a more low in the marketplace in 2015, and it's been moderating since then. Our expectation going into 2018 that we'll continue to see that moderation, but not at the same rates that we saw in 2017. Once again, we're not just sitting back. We're trying to work with our customers, continue to provide opportunity for those customers to continue shopping with us in a more advantaged way and continue increasing our penetration.

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

I guess, the only thing I'll add, this is Marvin, is when we look at big-ticket categories, like Appliances, roughly 70% of our clients' purchases are done on a JCPenney credit card. So our credit portfolio is a significant strategic advantage to some of these big-ticket categories, so credit is important. And as Jeff mentioned, we'll continue to work at what think it gives us in the future, a competitive advantage. We just have to work through some of the short-term issues.

Operator

And our next question comes from the line of Paul Trussell from Deutsche Bank.

Damon Joseph Polistina - *Deutsche Bank AG, Research Division - Research Associate*

This is Damon on for Paul. Just looking at real estate, would you assess the potential to close additional stores in 2018? And kind of how do you think about what metrics are most important when thinking about real estate?

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

This is Marvin. I'll take the first part of that and Jeff can feel free to add any additional color. We've announced that we're going to close roughly 8 stores in 2018, and it's a combination of a couple of reasons. First, we look at the monetization of real estate. We have a location in New Jersey that provided us with a better economic value to monetize it. And we felt like that was a better benefit from a financial perspective to the company, so we always look at the monetization opportunities. Secondly, we look at upcoming leases. And we make the determination if the marketplace supports us of re-upping the lease, so to speak. And also, we look at just overall financial performance. And in the case of the 8 stores we're closing, the decision to close kind of falls in all 3 of those definitions. As we look forward, as I mentioned, we have malls that we understand may not have

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long-term viability, but that number is 50 or less relative to what we are projecting and predicting, anchor closures, based on the trends that we've seen and based on the retails we share malls with. And it comes down to really one simple fact; does the mall have the appropriate capital resources to redevelop if an anchor closes? And we spend a lot of time, as you can imagine, with our mall operators to understand what their capital position is. But in addition to that, it affords us a terrific opportunity for renegotiation and to make sure that we're continuing to lower our rates and to renegotiate deals that are in the best interest of our company. And so we look at all of those things, and we have a commitment that we're not going to be in a location that's not financially viable for us long term. And that's why we closed 141 stores last year, but only 8 stores this year.

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

And the only thing I would add to that would be that we only have less than a handful of stores that do not have positive 4-wall capital -- or cash flow. And as such, as we look at in the marketplace, those locations that also provide a great brand recognition for us in the marketplace with respect to dot-com also, which is a point of distribution for us, it's a point of return, and it's an opportunity for us to continue growing in that particular zip code. So it's a -- we have to really balance all those things as we think about what stores we might want to not move forward with.

Damon Joseph Polistina - *Deutsche Bank AG, Research Division - Research Associate*

And one more follow-up. On SG&A, you expect to be down in 2018. Did -- are you able to break out kind of where you see those savings coming from? And how do you balance that with the need to invest in digital, your omnichannel initiatives, wages, et cetera?

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

No, it's a balancing act. And quite honestly, as we continue to look in our stores at increasing our productivity, opportunities for us to continue using our Mobile Warrior device to allow us to be more effective in how we allocate cash can actually complete those tasks, as we think about opportunities within our supply chain and how we flow inventory and how it impacts the stores. But Joe McFarland is here with us also. And maybe, Joe, if you want to add a little bit more to our opportunities in the store base.

Joseph Michael McFarland - *J. C. Penney Company, Inc. - EVP of Stores*

Yes. Thanks, Jeff. So we announced in the press release this morning a realignment of what we're doing inside the stores. We've really done that to capitalize on what we have the associates doing to remove tasks from the store. We are laser-focused on the amount of time that our associates spend on things like backroom activity, on things like unloading trucks, on very manual processes. And as Jeff mentioned, we have had a multi-year roadmap that will continue for investments in our Mobile Warrior to speed up processes in the store, to get our associates more customer-facing and less task. So we feel very good about the investments we're making, the ease of the customer shopping experience and making the customer shopping experience the priority versus the tasks that we've been focused on.

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

And the last thing I would add is that we have Marci who has been extremely talented in looking at how we're spending our marketing dollars and our cost of customer acquisition, the implementation of different opportunities within digital marketing as well as what we're doing in preprint and other direct mail.

Operator

And our next question comes from the line of Chuck Grom from Gordon Haskett.



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

On the expectation for better comps in the first quarter, curious your assumption for the calendar shift year. And then on February trending above 2%, just great news. Curious if women -- Women's and kids are also trending better.

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

Chuck, the answer is the apparel components of our business are performing exceptionally well. And Women's and kids are helping to carry the positive trend that we're seeing in February. And what's interesting is that's occurring even before we are fully set in all stores for Spring. But the momentum is something that we're pleased with. We know we have to continue to maintain it. As we look at the shift, I mean, we typically don't get into the nuances of shifted versus non-shifted because it becomes very confusing. But when we look at the comp performance and we look at what we're forecasting relative to what we are seeing, thus far, we feel good about the ability to over-perform. And we just to have to execute to make that happen.

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

Okay. Helpful. And then just on the digital side, can you just take a step back, remind us where you finished in digital penetration in 2017 relative to 2016, what the growth was year-over-year? And then just when you think about the drivers of that, how much of that was the 50% increase in the SKU count? And what is your exact SKU count today?

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

Well, Chuck, this is what I will answer for you. We're not going to get into the exact SKU count. What I can tell you, our penetration is approximately 18% of sales, which we know that number is going to continue to grow. And it's one of the reasons why the investments, the trends cited in the store from a structural standpoint and the metric that's 40% of our online orders are fulfilled from a store is significantly important to us because the more we can do that is the more we can get the product to the customers based on their desire on how they will fulfill it, whether they will pick it up in the store or whether we ship it from a store. And our growth is approximately 20%, which we're excited about. And we think that, that is something that we can sustain. And for SKU count, I mentioned, we're going to add roughly 600,000 SKUs this year. We added -- we increased SKUs by 50% last year, and we'll kind of leave it at that from the standpoint of what we have as far as items online.

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

Okay. Great. And then just one last one for Jeff just to be clear. On the '18 EPS guidance, that excludes the \$45 million of pension income, but it does include the \$50 million to \$60 million of asset sales. Am I thinking about that right?

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

Yes, you are.

Operator

And our last question will come from the line of Dana Telsey from Telsey Advisory Group.



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

As you think about the active category that you've referenced, where are you now in penetration? Where could it get to? And how is the margin on that versus the corporate average? And then with wages, what is the strategy with wages? How are you thinking about it going forward? And then just lastly, in terms of online, any color on category performance, how big online is as a percent of sales and where it goes?

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

So I will -- I'll take the online first. We mentioned the penetration of online is roughly 18%, and we think that number will continue to grow. From a category performance, I mean, it's really across the board. Our jewelry business is incredibly strong online because the value is so relevant and our assortment is vast from a value customer to a customer that really wants to spend an exceptional amount. We can really serve all of those customer needs. The Home business is incredibly strong online, and we have really great strength across all Home categories. And as I mentioned, the apparel business also carries enormous strength online. So we're very pleased across multiple categories. Relative to active, what I mentioned in my prepared comments is that what we're going to do for 2018, specifically in Women's Apparel, is make an investment in the expansion and setting up store shops with the Adidas brand, which, you know, is incredibly hot right now. We're going to continue to lean into our great partnership with Nike and we're going to extend items in categories in that space, and we're seeing nothing but positive results. We're going to be launching Puma, Champion and Copper Fit. And again, we're excited about those brands because our customers are responding well to those brands. And we're also very pleased with the performance of our Xersion private brand. The styles and the value of that brand are really un-comparable across any of our competitors. From a margin rate standpoint, I think, across the industry, it is pretty well known that active apparel is going to be slightly dilutive to the overall Women's Apparel margin rate, but that's nothing new. As you know, Women's Apparel is one of the healthiest margin rate categories in our store and it's one of the main reasons why getting this business to a positive comp is essential for us because that business carries such a strong profit margin that when that business performs well, it helps the entire company. And as I noted in my prepared comments, one of the reasons why we had a 50- basis points improvement in gross margin in the fourth quarter was the improvement in the Women's, kid's and Men's business, which really helped to offset any margin headwinds that we had. So we think we have a really good active strategy. We're going to be making investments in this, and you'll see that in a very material way heading into the latter part of the spring season, into Back to School and throughout the whole year. And our Chief Customer Officer, Joe McFarland, is here and I'll let him answer the wage question, so you can have some perspective.

Joseph Michael McFarland - *J. C. Penney Company, Inc. - EVP of Stores*

Thank you, Marvin. And Dana, as far as wage goes, we continue to be in a very competitive wage set. The simplification efforts that we have been instituting in the store, really, have allowed us to remain very competitive. We monitor very closely every individual market. We know the most competitive markets that we're in. And through the task reduction, through the simplification efforts, we feel very confident in our ability to take and reinvest in the wage in our growth areas. If you think about Appliances, if you think about Sephora, we have been able to really invest in those areas, attract high caliber of associates that are really experts in what they do. We'll continue to stay laser-focused. We'll continue to make changes throughout the store and continue to make sure that our associates are competitively paid in the marketplace.

Operator

And this concludes our question-and-answer session today and today's conference call. Thank you for your participation. You may now disconnect. Everyone, have a great day.



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