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JCP - Q3 2019 J C Penney Company Inc Earnings Call

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OVERVIEW:

Co. reported 3Q19 adjusted net loss of $97m or $0.30 per share.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q3 2019 JCPenney Earnings Conference Call. (Operator Instructions)

I would now like to introduce your host for this conference call. Ms. Kelley Buchhorn. You may begin.

Kelley Buchhorn - *J. C. Penney Company, Inc. - Head of IR*

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

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

With that, I'll now turn the call over to Jill.

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

Thank you, Kelley, and good morning. The past quarter was an exciting and energizing time at JCPenney. As you saw in our release this morning, we increased our adjusted EBITDA expectations and reaffirmed all other financial guidance metrics for full year 2019. We delivered meaningful gross margin improvement this quarter, driven in large part by increased enterprise selling margins, improved shrink results and the exit earlier in the year of major appliance and in-store furniture categories. Inventory levels were down 9% at the end of the quarter and down 14% when compared to the end of the third quarter 2017, reflecting our continued discipline and commitment to improve inventory management and productivity. This was our plan, and we are pleased with the results.

Bill will cover our financials. But before we do that, I want to provide further detail on our strategy to return JCPenney to sustainable, profitable growth.

On our call last quarter, I referenced our focus on renewing the business. While I am pleased with our continued progress on inventory management, gross margin improvement and adjusted EBITDA, we are laser-focused on our plan for renewal. Today, I'd like to share the 5 components of that plan. Coupled with our deep understanding of the customer, these components guide everything we do. These components are: Drive traffic, offer compelling merchandise, provide an engaging experience, fuel growth and build a results-minded culture.

Let's get right to it. Understanding these components will clarify all the work we have done and where we are going. The 5 components of our plan for renewal reinforce and drive one another, and I want to take some time to share each with you. I am confident in the strategic choices we've made. And by implementing them, we will restore JCPenney to profit, growth and our rightful place in the retail industry.

Over the past year, we have worked tirelessly to better understand the customer. So when we think about the best way to deliver the first component of our plan for renewal, drive traffic, we know we need to deliver something different. We view our footprint in malls as a way to engage in new ways with customers, using our space to present our merchandise with a fresh approach and provide experiences and services that customers want and are giving us permission to offer.

We know a lot about our customer focus segment. We conducted holistic research that was broad and deep, speaking to thousands of retail consumers that included those who shop us, those who used to and those who don't even consider us. Our efforts are centered on psychographics and knowing what drives a customer attitudinally and behaviorally, truly understanding what's important to them.

Our customer focus segment is the all-in shopping enthusiast. Learning what this customer wants and what we are not delivering is shaping our actions across all channels so we can drive traffic and capture more share. The all-in shopping enthusiast lives life to the fullest and seeks the most out of everything. They are the most confident in their style vision yet most open to input and expertise. They are most willing to invest the time and money to get it right. They are the most excited by choice and innovation and are most connected with their family, friends and community. They pride themselves in making life happen for their loved ones.

This shopper told us they like the mall. These are serious shoppers who respond to compelling merchandise and engaging experiences. Our research shows that the all-in shopping enthusiast represents over 1/4 of all home and apparel retail sales. And the good news is they are already shopping with us. We need to deliver on what is imperative to this customer, allowing us to capture more of their wallet. And by getting it right, it will halo onto other valuable customer segments.

We need to connect with them on important emotional drivers, and they told us that no retailer is consistently delivering on these key imperatives. The all-in shopping enthusiast has told us they want a retailer that reflects their lifestyle and makes them feel good about themselves; truly understands the important moments in their lives, big and small; is a place that's fun to shop and share with others. As we think about every element of the shopping experience, the exploration, the discovery and the purchasing in store, online and through our app, we are working to connect with them on these emotional drivers.

We know that nearly 90% of customers begin their path to purchase online. We continue to work on our e-commerce experience to drive traffic across all channels. We are building a viewpoint of what needs to be done, and customers will continue to see incremental improvements over time. Our marketing approach that began this quarter and continues into holiday exemplifies customer centricity in every aspect. Our brand voice established -- establishes differentiation for JCPenney. This, combined with heavy-lifting communications, support our promotional events.

We do not see brand and driving traffic as separate pursuits. They complement each other across every media channel to grow confidence in and preference for the JCPenney brand, which leads us to the next component of our plan for renewal: Offer compelling merchandise, another -- a significant driver of traffic online and in-store.

Since she joined JCPenney earlier this year, Michelle Wlazlo, Chief Merchandising Officer, and her team, have been hard at work on our merchandising strategy. They began their journey influencing the fall and winter collections by reenergizing our private and national brands. Spring will mark the first collection her team has managed from start to finish, yet what they had done with the current collections is resonating with the customer.

Our Fall For You event, which focused on hues of brown & spiced latte and featured animal prints from brands including Worthington, a.n.a and Liz Claiborne, exceeded our expectations. In Levis, we are encouraged by the customer response to our expanded offering. In addition to great denim, we've added relevant pieces, including t-shirts, jackets and other layering items, so our customer can complete their look.

We also had a strong start to our recently launched men's outdoor shop. Categories such as sweaters, heavyweight wovens and shirt jackets performed well from both private and national brands, including St. John's Bay, Hi-Tec, American Outdoorsman and American Threads.

The all-in shopping enthusiast is driven by style and newness, and continuing to deliver on this is key. Furthermore, understanding how this customer lives their life is critical to our success. Through our extensive consumer research, we identified the 5 lifestyles which shaped our approach to merchandising in a way that would resonate with our customers and how they want to shop. This will enable us to make an emotional connection with the all-in shopping enthusiast. We are merchandising by these lifestyles which will inform all product decisions and future experiences.

These lifestyles, representing important moments in the customers' day, week and life, are: Move, for everything from low to high impact; chill, for the stylish 5-to-9 you, plus great lounge and sleepwear; all day, for casual workwear and weekend wear; on-point, for when you want to be a bit more refined and polished; shine, for those special occasions.

Our clearly focused lifestyles will provide the framework for our brand architecture. Each brand, private and national, serves a purpose within these lifestyles, delivering the looks our customers want. We started first in women's, and we will extend this architecture to men's, Children's and home.

As I mentioned on the second quarter earnings call, Stacy Shively recently joined the company as Senior Vice President, GMM Home. She is developing a comprehensive strategy which includes adding and intensifying key national brands that are already resonating with customers. These include instant Pot, Keurig, Ninja, Brookstone, Sharper Image and more. These early efforts are encouraging, and we will have more to share in the future as we reestablish our dominance in the home category.

Another element of providing compelling merchandise is our visual merchandising strategy. Visual merchandising brings the product to life and inspires shopping through storytelling. It's how the customer connects and finds themselves in a retailer. It encourages wardrobing and makes putting outfits together easy. It may seem obvious to have visual merchandising in a department store, yet it is something JCPenney had moved away from in the past, and that was a mistake.

Through our research, we know that visual merchandising, coupled with proper inventory management and of course the right product, creates an emotional connection with the customer, which is another step to driving traffic and sales. With these insights, we tested visual merchandising in women's within the 5 lifestyles. Given our initial results, we recently implemented this strategy into 92 stores to start. We are currently measuring the impact and will continue to refine and expand this effort in a way that best serves the business.

As I referenced earlier, the all-in shopping enthusiast likes the mall. But we know we need to be more than a department store, which brings us to our next component: Provide an engaging experience. The all-in shopping enthusiast told us that they want a great experience, both for themselves and to share with friends and family. Last quarter, we told you about our test-and-learns, which were 4 single-store concepts, most notably the styling room. We took our learnings and incorporated 3 of the tests-and-learns, along with the lifestyle merchandising and visual merchandising, into a single store. Our learnings and the performance of that store gave us the confidence to move forward.

Nothing embodies the effort to provide an engaging experience more than the recent grand opening of our brand-defining store in Hurst, Texas. Before I talk more about that, I want to be clear that the brand-defining store is an investment in our future. Our brand-defining store is not a prototype to roll out across all our stores and it is not a flagship store. Our brand-defining store is the fullest articulation of our customer strategy. It is a store where we can leverage learnings from customer feedback yet also observe customer preferences and shopping behaviors. It provides an inspiring shared experience and engages customers in new ways.

It's a lab. There are over 100 touch points that will inform future actions as part of our broader strategy, putting the customer at the heart of everything we do to return JCPenney to sustainable, profitable growth. The store showcases our compelling products and brands that our customers know and love. Our brand-defining store brings together every touch point and initiative from our research and the test-and-learns, including lifestyle merchandising, visual merchandising, product adjacencies and cross-merchandising.

In addition, customers have consistently told us that they want us to make their shopping experience easier and a fun place to share with others. We've created differentiating elements that will deliver on these imperatives: Our first-ever men's styling room, and of course, our women's styling room with dedicated style experts and innovative technology to get new sizes or colors brought to your fitting room; a destination to complete the look, the All-You zone, showcasing fashion jewelry and accessories; a new open concept Sephora inside JCPenney; and a reimagined salon by InStyle, which includes spa services; the Barbery, Penney's first-ever barbershop for a fresh cut, shave or shoe shine; Style + Substance Lifestyle Workshops; the Movement Studio, offering instructor-led fitness classes.

We've created a kids destination complete with a clubhouse and interactive digital art with our authoritative Disney shop at the center. There are 11 lounges, including a café and a bistro powered by a local partner. And the Shutterfly Picture Pop Selfie Studio, the first ever of its kind. And not to forget the many social media moments around the store and so much more.

We know the all-in shopping enthusiast is not loyal to one store or brand. By offering both compelling merchandise and engaging experiences, we will engage differently to drive traffic and capture more share. To deliver on that commitment, we must fuel growth, our fourth component, through gross margin improvement, SG&A efficiency and an optimized capital structure. In a few moments, Bill will go into more detail on our progress on this important component of our strategy.

Which leads me to the final component of our plan for renewal: Build a results-minded culture. As I've stated before, the only way I know how to rebuild a business is through a holistic approach across all the key tenets of strategic, purposeful and effective retailing, and having the right team is critical to achieving this.

We are developing a results-minded culture focused on accountability, urgency and innovative problem-solving at all levels of the organization. This includes senior leadership that we continue to build with a blend of talented JCPenney veterans and new talent. We have attracted top talent in the industry, some of the best and brightest who have been through good times and bad. They understand the fundamentals of retail and they also know what it means to innovate and transform.

As you may have seen, Laurie Wilson recently joined us as Senior Vice President of Pricing, Planning and Allocation. She brings over 20 years of executive leadership from Macy's. Laurie's extensive experience in planning and allocation, merchandising, pricing, omni-channel and operations will play a significant role as we focus on our immediate actions, including restoring disciplines required to enhance inventory management and lower our cost of goods sold. All these leaders are in place to support our team, and we have made progress in how we operate at every level of the company.

We are building a culture that connects each associate to achievements larger than the individual. It's imperative that all our associates understand where we are going as a company and how their role contributes to our success and are innately connected to our plan for renewal. There is renewed energy and a sense of clarity at Penney's. By maintaining the momentum, I am confident we will reach and exceed our potential.

Now I will turn the call over to Bill, who will provide an in-depth financial update on the quarter. I will return to close out the call and take any questions you may have. Bill?

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

Thank you, Jill, and good morning, everyone. It's a pleasure to join you on the call today.

As Jill mentioned, the fourth component in our plan for renewal is fuel growth. We are confident we can fuel the profitability of our operating performance by taking out unnecessary or unproductive SG&A expense, improving shrink, effectively managing our inventory and improving our cost of goods sold. As part of this plan, we have identified and are implementing cost reduction and efficiency initiatives across the organization that include reducing demand, achieving benchmark-level performance across categories and being more disciplined in our approach to results management. Furthermore, we will improve the health of our balance sheet and capital structure.

Additionally, an important component of fueling growth and building a results-minded culture includes a strong team of financial leaders who understand our overall retail environment. During the third quarter, we hired a key member of this team, Colin Dougherty, as Senior Vice President of Finance, to lead in the areas of financial planning and analysis. Colin brings with him 25 years of experience in both retail and finance with companies including U.S. Bank, Target and Hudson Bay. As we move through our plan for renewal, he will be an integral part of this team.

Now let me take you through the results of our third quarter. As reported earlier this morning, we delivered a significant improvement in gross margin rate, an increase in adjusted EBITDA dollars and a further reduction in inventory. Additionally, we ended the quarter with approximately $1.7 billion in liquidity.

Total net sales decreased 10.1% for the quarter. Comparable sales decreased 9.3%. The exit of the major appliance and in-store furniture categories had a negative impact to comp sales this quarter of 270 basis points. As such, when you exclude this impact, adjusted comp sales decreased 6.6%. The comp sales decline was primarily driven by a decrease in transactions, partially offset by an increase in average transaction value.

As expected, top line sales faced headwind pressures from aggressive promotions in the third quarter of last year to drive the liquidation of slow-moving and aged inventory. These internal headwinds will continue to affect sales in Q4.

In terms of specific results, our top-performing merchandise categories in the quarter included fine jewelry, footwear, men's and women's apparel. Denim was strong throughout all apparel divisions this quarter, especially in kids. We updated our denim assortment for the back-to-cool -- back-to-school season and drove more dominant positioning of our denim national brands. Overall, back-to-school shoppers came out later this year with customers buying closer to seasonal need.

Our fine jewelry business once again delivered solid sales results with positive comps in categories such as modern bride, diamonds, gems and silver.

Men's apparel sales outperformed all other categories. For the quarter, we delivered double-digit comps in branded athletic apparel as well as mid-single-digit comps in both licensed team apparel and men's big and tall. Some of our top-performing brands included Collection by Michael Strahan, Shaquille O'Neal XLG, Champion, Puma and adidas.

Women's apparel outperformed our go-forward business comp with casual sportswear, career separates and dresses performing better overall. Private labels a.n.a and Liz Claiborne both delivered positive comps during the period.

Credit income for the third quarter was $116 million compared to $80 million in the third quarter last year. The improvement over last year is primarily due to higher gained share resulting from improved performance of the credit portfolio. As a reminder, our new credit agreement with enhanced economics went into effect during the fourth quarter last year. And as a result, we do not expect such significant improvement in year-over-year credit income to continue.

Cost of goods sold for the third quarter was 64.6% of net sales, a decrease of 350 basis points compared to the same period last year. The decrease was primarily related to an increase in both store and online selling margins and improvement in our shrink results and the exit of major appliance and in-store furniture categories.

For the quarter, both nonclearance and clearance selling margins were once again up year-over-year. We delivered a significant improvement in both stores and online clearance selling margins, which on an enterprise level were positive in the high mid single-digit range. Additionally, total selling margins improved in nearly every division in Q3, reinforcing our expectations for improved underlying gross margin performance for full year 2019.

Now moving to expenses. SG&A expenses were $854 million, down $29 million when compared to the same period last year. The decrease in SG&A dollars was primarily due to lower advertising and store controllable expenses which were offset by slightly higher incentive compensation. As a reminder, SG&A expenses last year included a $26 million benefit resulting from the sale of the leasehold interest in our Laguna Hills, California store. With the adoption of the new lease accounting standard starting this fiscal year, we recorded approximately $5 million in SG&A expense related to the home office lease in Q3 this year. In addition, last year, the home office lease was recorded as depreciation and amortization and interest expense. Net interest expense this quarter was $73 million.

Our adjusted net loss was $97 million or $0.30 per share for the third quarter this year, an improvement when compared to last year's adjusted net loss of $164 million or $0.52 per share.

Next, our capital structure, liquidity and balance sheet. As part of fueling growth, we've been engaged in reviewing our overall capital structure. We have outlined 3 main objectives. First, we will continue to maintain more than adequate liquidity to fund the operations of our business. 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 $429 million in outstanding borrowings compared to $437 million in 2018. As such, our liquidity position at the end of the third quarter was approximately $1.7 billion.

Second, we will proactively manage our existing debt maturities. During the third quarter this year, we paid $50 million of unsecured notes at maturity, bringing our year-to-date debt repayment to a total of $86 million. We have very manageable near-term debt maturities with $105 million of unsecured debt maturing in June of 2020.

And third, we are maintaining flexibility in how we fund the business to ensure sustainable and profitable growth. With that, we are taking positive and proactive measures to enhance our capital structure and to improve the long-term health of our balance sheet.

Cash and cash equivalents at the end of the third quarter were $157 million. Capital expenditures were $226 million for the first 9 months of 2019. For the first 9 months of the year, free cash flow was a use of $518 million, which is a decrease in cash flow of $18 million when compared to last year. We continue to expect free cash flow to be positive for full year 2019.

Inventory at the end of the quarter was $2.93 billion, a decrease of $289 million or 9% when compared to the end of the third quarter last year. The decline was primarily due to lower basic inventory levels this year compared to the same period last year. Additionally, the full liquidation of our appliance and furniture floor model inventory accounted for $86 million or approximately 2.5% from our third quarter inventory reduction. When compared to 2017, inventory was down $470 million or 13.8%. We remain committed to restoring the discipline required to enhance inventory productivity. And as a result, we believe our inventory levels will continue to be a source of working capital in 2019.

Merchandise accounts payable were $1.1 billion, down $129 million or 10.5% versus the end of the third quarter last year. The reduction was primarily due to our reduced inventory position and is in line with the seasonal increases we expect in months leading into the holiday season.

Turning now to guidance. We are reaffirming our financial guidance for the full year 2019 as follows. Comparable sales are expected to be in a range of down 7% to down 8%. Adjusted comparable sales, which excludes the impact of our exit from major appliance and in-store furniture categories, is expected to be in a range of down 5% to down 6%. Cost of goods sold as a rate of net sales is expected to decrease 150 to 200 basis points compared to last year, resulting in an increase in gross margin of the same amount. And free cash flow is expected to be positive for full year 2019.

Additionally, we have increased our adjusted EBITDA guidance to the upper end of our prior range as we now expect adjusted EBITDA to exceed $475 million. As a reminder, our 2018 adjusted EBITDA included a $70 million benefit primarily related to the buyout of a leasehold interest in 2 stores last year. In addition, we will record approximately $20 million in home office lease expense in SG&A this year, which last year was recorded as depreciation and amortization and interest expense. When combined, these items account for an approximate $90 million headwind to last year's adjusted EBITDA.

With that, I'll now turn the call back over to Jill.

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

Thank you, Bill. Reenergizing the JCPenney brand is about knowing what is in the hearts and on the minds of our customers. We are staying true to our DNA yet innovating and differentiating based on the customer insights we've captured and what they are giving us permission to be for them. We have defined our strategy, our plan for renewal. We continue to take a do-then-say approach, and I will provide updates as we make meaningful progress.

As I've said, we are not simply running a business, we are rebuilding a business, and it will take time. I would like to thank our shareholders and vendor partners for their support. I would also like to thank our over 90,000 dedicated and passionate associates, each and every one, across our entire company, for their hard work, dedication and commitment to our customer. They are the centerpiece of our brand.

JCPenney is a 117-year young American retail icon that is very important to our customers and hundreds of communities throughout the country. This company has a rich history, and I am confident it has an even brighter future.

With that, 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 Oliver Chen with Cowen & Company.

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

Jill, regarding women and your thinking and your framework around move, chill and all day, what are your thoughts on the biggest priorities and needs? And also your thoughts on in-store navigation and then managing inventory levels in store for the customer experience that's curated and convenient?

And Bill, we were also curious about free cash flow that is trending a little bit lower. What gives you confidence that you can reach your guidance?

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

Thanks, Oliver. Well, the way in which we determined was the best way to merchandise for our customer was based on what the customer told us is important to them and how they live their lives. And I'm a strong proponent of not being a retailer that tells customers how to live their life but to understand how they live their lives and really embody this idea of making shopping easier. The whole reason I took this job at JCPenney is because I understand how hard it is to shop and how hard it is to find your style. Customers really want to connect emotionally with their retailer. They want to go into the store or on the site and just feel like a retailer gets them, that they can find themselves.

And so as we think about what needs to be done, we are developing holistic brand architectures that encompass the 5 lifestyles. And each brand, both private and national, will play a specific role within this brand architecture to make it easy for the customer to understand what we stand for, for them, easy for them to find their style and easy for them to put looks together.

And as we think about how to merchandise this on the floor, that's what we've been testing and bringing to life, first with some of our early tests-and-learns and then in our -- the 92 stores that we expanded the test in. And then there's a full embodiment of this in the brand-defining store.

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

Oliver, and to answer your question on free cash flow. On a year-to-date basis, the real delta on -- when you think about $518 million versus $500 million is the cash proceeds from the sale of assets on a year-to-date basis in Q4. Obviously, we've annualized that at this point. And I think our operating performance in Q4 is going to allow us to -- we're comfortable in the range of having positive free cash flow for the full year.

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

Okay. And lastly, the holiday season, we're worried about it being highly promotional, especially for women's apparel and the weather behaving in a mixed way as well as the calendar being unfavorable. So what are your thoughts on the promotional environment and how you're prepared, the key differences this year versus last year? And what you think the consumer environment will be, and any -- as well as your strategy?

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

We're excited for the holiday season. And as I mentioned on the last call, JCPenney will show up differently. Our marketing campaign is already in market. And it really is the first step of us connecting differently with our customers. We know that the holidays can be a frantic time, and we don't want to contribute to that. We want to do just the opposite and helping our customers to remember the great things about the holidays. Our campaign is remember the little things. And we're standing that up through our merchandise and also our website and our physical stores, in our marketing communication, so that the customers can really start to develop that emotional connection.

We have an exclusive partnership with the Hallmark channel that we just shared out recently. We have Santa photo opportunities within many of our portrait studios. We are encouraging customers to remember the little things through our social media engagement, #MemoryMade. And this is all coupled with the incredible product that we have in our stores as well as an easier shopping experience through the reduction of inventory that we've been able to achieve.

And as it relates to the customer feeling, we share the industry view that the consumer continues to be in a good place right now, low unemployment, better wages. And we'll just continue to monitor consumer confidence.

Operator

Our next question comes from Matthew Boss, JPMorgan.

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

Great. So maybe to start with same-store sales. Near term, could you just walk through the drivers of the 200 to 300 basis points of sequential improvement, excluding in the appliances and furniture that's implied in the fourth quarter guide? Maybe just versus the sequential deceleration in the last 2 quarters that we've seen.

And then Jill, beyond maybe the third or the fourth quarter, could you just elaborate on the phasing and time line for implementation of the in-store initiatives for us to monitor going forward?

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

Yes. And I'll take the first part and Jill can grab the second. I think when you look at it sequentially on our comp store sales and even if you were to look at it on a 2-year stack basis, have been relatively consistent. When you think of kind of what we've guided for in -- for full year and the implications of that on Q4, I think, again, you're going to see kind of consistency in what we've kind of laid out in terms of our expectations.

In addition, we did move away from some unprofitable promotions that we were running, especially in Q3 of last year, as we look to just drive more profitable sales and not run things that are obviously inefficient for the customer and for our business. So our full year guidance kind of implies that changing trend, and we don't expect anything different.

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

So Matt, I'll jump in here. In terms of the phasing and time line of the in-store initiatives, as I mentioned, we've been testing all year, first started to stand things up in March that I shared last call,in order to get early reads on our hypotheses and get customer feedback. And then -- and we went on to broaden that a little bit in July. And then, obviously, the recent addition of adding some of our lifestyle merchandising, visual merchandising into 92 stores, where we're continuing to read and monitor that and determine the best course forward, which led to our grand opening just 2 weeks ago of our brand-defining store here in Hurst.

So we are very early on this journey. And the brand-defining store has over 100 components, 100 touch points within the store that we are actively measuring and monitoring and reading and will determine the best course forward based on what the customer says. Certainly, we all are working with a healthy sense of urgency here at JCPenney. But at the same time, we are going to ensure that we are making the right decisions for the customer and the right decisions for the business. And you have my commitment that I will keep you on this journey with us.

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

That's great. And then maybe just a follow-up on the gross margin. What's driving the implied moderation in the fourth quarter gross margin expansion relative to the performance that you just delivered in the third quarter?

And just any way to size up the gross margin opportunity in terms of ranking the biggest opportunity as we move past this year?

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

Yes. Matt, I'll take the second part of that first, on kind of -- we're not going to give guidance on 2020 in terms of how do we think about any level of margin expansion. If you look at we've guided 150 to 200 basis points on the full year this year and that the year-to-date is on the upper end of that, I think the reason -- not so much moderation. And the big pickup's been in the last quarter -- 2 quarters, but it's really because when you look at our most promotional time of year from a margin rate perspective, it comes in Q4, right? And so you're going to see a little bit of a balance associated with that, and that's what was implied in our guidance.

Operator

Our next question comes from Chuck Grom with Gordon Haskett.

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

I guess a few questions for me. First, credit revenue, obviously Bill, has been real strong. I know you're talking about directionally it being slower. But maybe if you could just help us on the fourth quarter guide. That's the first question.

Second, on the comp, you've unpacked the 270 basis point drag from appliances and furniture. Just wondering if you could potentially quantify what the promotional drag was from last year as you guys cycle that.

And then -- and third would just be, when you look at the core business, the underlying business in the third quarter, can you just talk to maybe the cadence of sales and how it progressed throughout the quarter? And then anything over the past couple of weeks now that the weather has clearly broken throughout the country.

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

Yes. Okay. And Chuck, you squeezed like 4 in there, man. Let me take the first one. So the credit income.

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

I can go through them again if you want, though. Sorry about that...

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

No, no. I got them all. No, we're good. So credit income on a year-over-year basis, we really had the big pickup in Q4 last year. And so when you look at it, so that's 4 straight quarters where we've had a really big pickup, you are going to see a moderation on year-over-year. We're not going to pin an exact number on it. But what you're definitely not going to see is a similar level of pickup as you saw in Q2 and Q3. Okay. That's the first.

On -- second, on as you think about the comp drag related to promotions, if we were going to size the prize, and we ran promotions such as things like additional percent off and things like that, that become a little bit of a drug in terms of how you're trying to drive sales. You'd size that kind of roughly 100 basis points of drag when you think about the quarter. Okay. And those are some of the things we walked away from that allow us to drive more profitability and healthier sales that we did drive in the quarter.

From a sequential period and how do we think about the quarter, we did -- and our strongest month of the quarter was the last month. It was the third month of the quarter. So -- and we're not going to break down what the individuals were, but that was our strongest. So we did see a pickup as far as that goes and which we were pleased with. In terms -- and you're going to know the answer to this one already. In terms of the last 2 weeks, we can't give a, hey, how we're doing in-quarter.

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

Okay. Okay, great. And then just to kind of follow-up on Matt's question with regards to the new store and then the prototype. I guess why not start to accelerate some of those initiatives a little bit quicker? And I guess if you were to do that, like it seems like visual merchandising, you're pretty excited about. It makes a lot of sense. What's holding you back in terms of rolling it out more aggressively to the rest of the chain?

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

Well, as it relates to visual merchandising, we have put that into an additional 90-plus stores just recently. So we have moved on that effort. The -- it's just really critical for us to do what's right for the business. We're in this for the long term. We are reestablishing and rebuilding JCPenney to be around for the next 117 years. And I'd just take more of a prudent effort to ensure that when we do it, we do it right so that we can continue to appeal to customers and capture more share of the all-in shopping enthusiast's heart and wallet.

Operator

Our next question comes from Paul Trussell with Deutsche Bank.

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

Congrats on the progress. Wanted to maybe start with online business. How did you perform from an e-commerce standpoint? And what are some of the enhancements and capabilities you're working on with .com, app and fulfillment strategies?

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

Okay. Yes, Paul. I mean, obviously, we don't break out kind of e-comm performance versus in-store performance. The one thing that we did have last year is we were liquidating -- or the appliance business net flowed through our e-comm channel, right? And so obviously, that -- we don't annualize that on a year-over-year basis. But there's a lot of work being -- and Jill can take you through a couple of things that we've got underway. But we're not specifically carving out what e-comm is relative to in-store.

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

And we are really addressing many of the areas no different than what I've been consistent in, in the year that I've been in the role, that this organization has a lot of problems to fix. And we've been very overt on that. And it's both in our physical and digital space. So as it relates to our digital space, we are enhancing our customer experience, the user experience. We are making it easier to navigate. We are building out storytelling to drive that emotional engagement with the customer, make it easier to find what they're looking for as well as find their style. We've also been working on just the frictionless and seamless effort to shop cross-functionally between our digital and our physical space.

And as I mentioned, our customers will continue to feel the impact of our efforts over time. As you know, we can do this a little bit more quickly in real-time and faster. And we have a full organization focused on improving our mobile web, our website as well as our app.

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

And then just big picture, how do you feel about the store base? Any kind of updated views on store count long term or potential pace of remodels?

And then lastly from me, Bill, is just maybe just touch on what some of the drivers are of your reduction in expenses on a year-over-year basis.

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

In terms of our fleet of stores, we're staying very close to every store. We know exactly how each one is performing. We're doing future projections on what they will continue to contribute to the organization. We have nothing to share today, except that we are very close to our physical fleet.

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

Yes, and on the store expense -- around the expense piece, right, Paul. I mean, it's going to be a combination of leverage and maintaining leverage in terms of how do we balance on a rate of sales base. But then also, as I touched on as part of fueling growth, we've already started to go through and look at kind of benchmark-level performance in our SG&A expenses and have been really working hard across every function and category in the business to start to make sure that we're rationalizing those to the level that we feel is the right size for our level of organization.

Operator

Our next question comes from Michael Binetti with Crédit Suisse.

Michael Charles Binetti - *Crédit Suisse AG, Research Division - Research Analyst*

Could you help us, I guess, with a little more numerical help on unpacking the gross margin drivers a little bit in the quarter, I guess, between the callouts that you did have, the improvement in selling margins versus shrink versus appliances?

And then within the improved selling margins, I thought it was interesting that you had mentioned that both clear -- I think you mentioned that both clearance and nonclearance saw margins increase. Maybe you could help us think through just directionally how much each of those improved in the quarter.

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

Michael, I mean we're not going to get down to the basis point impact of my margin breakdown. I can tell you, though, like if you look at the exit of appliances, right? On a year-over-year basis, there is approximately a 50 basis point pickup as we moved out of that business, not only associated with the markdowns of it, but also associated to the fact that that's a lower-selling -- lower-margin selling item. So there's a large chunk of the mark.

In addition to that, just getting our pricing and promotion right. We started to make really good strides in that area, and you're starting to see a pickup that's flowing through. That's why you're seeing improved selling margins on both sides of the equation from a clearance and nonclearance basis.

Michael Charles Binetti - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. And then can I just ask you another question on the store portfolio? I guess I understand you don't want to disaggregate e-commerce versus physical stores. But I think your answer was that last year, we were liquidating some appliances. I'm assuming e-commerce trends were quite strong relative to the overall comp in the quarter.

It leaves us to backing out some fairly negative numbers in stores. Jill, I think you've done some media recently saying you don't see the need to close a significant amount of stores as we turn our eyes to 2020. But I do wonder, if you were to break down the store fleet into quartiles or something like that on profitability, how do you look at the level of traffic you have in stores today versus an improving trajectory on the full-price selling and the clearance margins as to how you see confidence in some of the lower-quartile, or however you define its, stores being go-forward sustainable on a 4-wall basis? It's a little hard for us to think through when we try to imagine what the traffic in some of the bottom tier stores might look like.

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

Thanks, Michael. And just to be clear, I've not given any direction on what we're doing with our fleet, closing or keeping open. All I've said is that we are very close to our physical fleet and understanding what each store is contributing to the total business.

As it relates to driving traffic, and then I'll pass it to Bill to answer some of your more technical questions. Retail is a dynamic business as you know. And this -- our approach at JCPenney is a very holistic effort. It's not going to be one single action that changes the trajectory of this organization, and I have been very clear on that for the past year. And as we think about driving traffic, whether it's to our physical footprint or to our digital spaces, it will be through differentiated products and services and experiences.

We need to engage with customers in new ways and develop that emotional connection that they're saying other retailers don't do. We need to deliver on the imperatives defined by the all-in shopping enthusiasts. Be the retailer that reflects their lifestyles, really understands them and make them feel good about themselves; truly understands the important moments in their life, both big and small; and is a place that is fun to shop and share with others.

Doing this in-store, online and in our app in addition to our physical stores is how we will return improved traffic levels to JCPenney. And we'll be communicating this through our marketing, through all the touch points. And as I've committed, we'll keep everyone in the loop on how our progress is.

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

And Michael, as you think about you're wanting to kind of put the stores into quartiles. I think the thing you're probably looking for, which is logical, is, hey, do we have this pareto of stores on profitability, where kind of some of the others falls off? And I don't think that's the way you guys should think about our store portfolio.

We're at 846 stores now. If you look at our occupancy cost as a percent of sales, it's actually relatively low. And we feel comfortable about the level of profitability of our store portfolio. Of course, we're always looking at making sure that we've got more efficiency. Then if there's something that we can optimize, of course, we're going to work through that. But what we don't have is this long tail of, hey, if you're trying to say, I can -- there's something to separate from the organization to enhance profitability in a significant way, that's just not the case. We really feel like -- that we've got an asset to work with here.

Michael Charles Binetti - *Crédit Suisse AG, Research Division - Research Analyst*

Can -- I should ask you, Jill, about -- you guys mentioned thredUP last time we talked. I'm curious how you're looking at the early stages of some of their e-commerce work that you guys have done since I don't think we talked about it much today.

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

Yes. Good point, Michael. We're still very early in our partnership with thredUP, which is currently in 30 stores. We don't have any additional information or announcements to make today about how that's going or any expansions. We are excited about creating a new in-store experience that makes it possible for our customers to get an expanded offering of brands, some brands that are considered more high end for our current customer base. And as you know, our partnership with thredUP caters to also eco-minded consumers that want more sustainable options in their wardrobe. So we're in the middle of the test, things are good, and we're just going to keep moving forward with it.

Operator

Our next question comes from Paul Lejuez with Citigroup.

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

Curious, which of the 5 pillars of the plan for renewal do you think kind of offer the lowest-hanging fruit? And I guess I'm kind of curious about as you think about all of them, what sort of required CapEx might be necessary? SG&A investment? Do you have cuts that you can make to offset whatever investments might be necessary?

And I guess just to go back to the store fleet again in a slightly different way. I'm curious if you're looking at the store fleet in terms of are there any stores that you might be looking to sell to raise some cash?

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

Thanks, Paul. Well, the interesting thing about retail is that you just can't get 1 thing right. And as you know, we took ample time to define our strategy, to determine what choices we would make in order to return this great company to sustainable, profitable growth, which has led us to sharing our plan for renewal. And honestly, I can't tell you one has the most low-hanging fruit. They all have to work together in order to reestablish and rebuild this organization from the ground up, restoring the health to the business while we innovate and transform.

As it relates to CapEx investments. A lot of what we're doing -- and Bill will chime in here, too. But a lot of what we're doing in the early test-and-learns, in the brand-defining store, are low capital investments and no capital investments. In fact, much of -- some of what's in the brand-defining store are components that are in all of our stores. Our great merchandise that our customer is responding to, our marketing campaign is the same for the chain. And all of our great associates, over 90,000 of them who have an infectious passion and -- about JCPenney, that they are excited to share with our customers every day. And we are supporting them so that they can help us really propel this company forward.

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

Paul, and in your question on, hey, are we looking to monetize part of the fleet to fund other growth? We haven't defined any plans as far as how do we think about the fleet from that perspective. Obviously, you know what our historic levels of CapEx have been; and for an organization our size, where that comes in at. And yes, there's a lot of things to invest in when you think about kind of our plan for renewal. But to Jill's point, they are very low capital. Part of the reason we're fueling growth is [build this] internally. What we're not doing is defining some store monetization plan or anything like that, that we've stated internally or publicly.

Operator

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

Heather Nicole Balsky - *BofA Merrill Lynch, Research Division - VP*

This is Heather Balsky on for Lorraine. In terms of your merchandising strategy, do you think you have the right national brand portfolio? And are you looking to add new brands, especially in apparel, or edit out any of your brands? And then I had a follow-up.

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

Thank you, Heather. We really believe in the complementary relationship of private and national brands working together. And we have incredible private brands and we have incredible national brands. And the national brands that we do have are very important to us, and we're really pleased with the partnerships and the work that we're doing together. We will continue to make them important and stand for them. And as I mentioned in home store, we've recently added or intensified some of our national brands. And each brand, private and national, will have and serve a specific role within our brand architectures across the 5 lifestyles that we are now merchandising within.

Heather Nicole Balsky - *BofA Merrill Lynch, Research Division - VP*

And just a follow-up. In terms of the floor space that used to hold appliances, can you just update us on what you're doing with the space, or work you're doing to I guess fill that space in your stores?

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

Sure. The floor space was dispersed on a by-store basis based on the changes that were made originally in each store to implement those merchandise categories. And then as we pulled it out, we looked again at each store to determine where there were opportunities to expand categories, reenergize categories. And we just did it on a case-by-case basis, store-by-store. So I can't tell you there was this 1 thing that we did in all stores.

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

It's not -- Heather, it's not like we had a standard prototype, that this is the model we rolled for -- yes.

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

Yes. We have different floor plans.

Heather Nicole Balsky - *BofA Merrill Lynch, Research Division - VP*

So at this point, is the space filled in for the majority of your fleet?

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

Oh, absolutely. Yes. The store experience was quickly addressed so that the customers wouldn't feel that there was this huge gap on the floor.

Operator

Ladies and gentlemen, this does conclude today's presentation. We want to thank you for joining and your participation. You may all disconnect, and have a wonderful day.