THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

JCP - Q3 2013 J C Penney Co Inc Earnings Conference Call

EVENT DATE/TIME: NOVEMBER 20, 2013 / 1:30PM GMT

OVERVIEW:

JCP reported 3Q13 total sales of $2.779b and reported loss per share of $1.94.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Kristin Hays *JC Penney Company, Inc. - SVP Communications*

Mike Ullman *JC Penney Company, Inc. - CEO*

Ken Hannah *JC Penney Company, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Matthew Boss *JPMorgan - Analyst*

Brian Nagel *Oppenheimer & Co. - Analyst*

Neely Tamminga *Piper Jaffray & Co. - Analyst*

Lorraine Hutchinson *BofA Merrill Lynch - Analyst*

Bernard Sosnick *Gilford Securities - Analyst*

David Glick *Buckingham Research Group - Analyst*

Will Frohnhoefer *BTIG - Analyst*

Dana Telsey *Telsey Advisory Group - Analyst*

Liz Dunn *Macquarie Research - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Quarter 3 2013 J. C. Penney Company, Incorporated earnings conference call. My name is Patrick and I will be your coordinator for today.

(Operator Instructions)

As a reminder this conference is being recorded for replay purposes. I would now like to turn the conference over to Ms. Kristin Hays, Senior Vice President of Communications. Please go ahead.

Kristin Hays - *JC Penney Company, Inc. - SVP Communications*

Good morning. Thank you, Patrick. As a reminder, the presentation this morning includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which reflects the Company's current view of future events and financial performance. The words expect, plan, anticipate, believe, and similar expressions identify forward-looking statements.

Any such forward-looking statements are subject to risks and uncertainties, and the Company's future results of operations could differ materially from historical results or current expectations. For more details on these risks please refer to the Company's Form 10-K and other SEC filings.

Also, please note that no portion of this presentation may be rebroadcast in any form without the prior written consent of JC Penney. For those listening after November 20, 2013, please note that this presentation will not be updated and it is possible that the information discussed will no longer be current.

With that I will now turn the call over to our CEO, Mike Ullman.

Mike Ullman - *JC Penney Company, Inc. - CEO*

Good morning. Thank you for joining us. I'm here with Chief Financial Officer Ken Hannah and we are glad to be with you this morning.

On today's call, I'll provide an overview of our third-quarter results and an update on the continued progress on our turnaround. I'll also discuss some of our objectives and plans for the fourth quarter, including the holiday season. After that I'll turn the call over to Ken who will walk through the third-quarter financials in more detail and then we'll be happy to take your questions.

Let me start off by saying that the turnaround at JCPenney is beginning to take hold. We're making significant strides toward restoring JCPenney to its rightful place in retail. The work we've been doing over the last seven months to stabilize the business financially and operationally required fundamental changes in many aspects of our business.

It's hard work, with no quick fixes, but our teams are rising to the challenge and our customers tell us they love the progress we're making. I'm pleased to report that, during the third quarter, we began generating positive sales momentum, which has enabled us to get off to an encouraging start in the fourth quarter. This is especially noteworthy in light of the still-sluggish retail environment and the pressures that our customer, in particular, continues to face.

Ken will take you through the details, but some of the key metrics for the third quarter were as follows. Comp store sales improved by 710 basis points from last quarter, ending the period down 4.8% year over year. This reflects sequential improvement in each of the three months in the quarter. Importantly, we reported positive comps in October, the first since December 2011. And it was a considerable achievement, given the impact of the 17 days of government shutdown during the month.

Women's apparel, men's apparel, and fine jewelry were some of the top performers in the quarter, especially in seasonal categories as the weather turned colder. Men's apparel, children's apparel, and home were the top performers online. Our private brands such as Worthington, St. John's Bay, and important national brands such as IZOD, Vanity Fair, Carter's, and others were strong sellers in both stores and online.

Our home category such as bedding, bath, window covering, and housewares were also strong in the quarter. Our customer is responding well to the remerchandising and rework we're doing in the home department. We look forward to having this substantially complete in spring 2014.

I'm pleased to report that our performance in November to date, fueled in good measure by our Biggest Sale of Them All, is consistent with the improved momentum we experienced in October. And we continue to expect to deliver positive comps for the fourth quarter.

Our margins are not yet improving as much as sales, but we are making progress. For the third quarter, gross margin was 29.5% of sales compared to 32.5% in the same period of last year. However, as with sales, gross margins improved sequentially throughout the quarter. Gross margin in the period was impacted by additional markdowns taken to sell through inventory associated with the Company's previous strategy, higher levels of clearance units sold at lower-than-expected margins, as well as the Company's transition back to a promotional pricing strategy compared to last year when the Company did not promote.

The good news, however, is we're putting back in place the components necessary to return to historical gross margin levels. First, we're working through the overhang of inventory from the previous management strategy. There are many brands and categories of brands that did not resonate with our customer. And we must edit those brands out of the assortment and sell through the goods. This takes time and it must be done.

Second, and very importantly, we have reinstated the engine of profit margin growth by getting our private brands back in stock and across our entire fleet of stores and jcp.com. As a percent of total sales, sales of private brand merchandise is returning to historical levels. And as we've said before, private brands carry 400 to 500 basis points of better gross profit margins than our national brands.

Third, we're restoring initial markups necessary to support the return to promotional department store strategy. The environment, as you know, is very aggressively promotional and we must and will compete to win. That means initially marking up our goods to sufficient levels to protect our margins when the discounter sale is applied.

Finally, we are putting processes and disciplines back in place to control inventory shortage in our stores. Shrinkage has increased approximately 100 basis points on margins in the third quarter and this cannot continue. Finally, expenses were well managed during the quarter and we continue to implement disciplines and processes across our organization.

Importantly, the Company's financial position is solid. Our total available liquidity is currently $1.71 billion and we still expect to end the year with more than $2 billion in overall liquidity. Behind our third-quarter results is important progress in areas that are critical to our long-term success, including merchandise assortments, marketing, home, and the growing strength of jcp.com, as well as our customer experience, which continues to benefit from the tremendous passion and commitment of our sales associates.

What I'd like to do now is provide a little commentary on each of these main topics. With regard to merchandise assortments, we continued to take steps in the third quarter to insure that the customer finds the merchandise she expects at JCPenney, including key private and national brands. Based on our improving conversion trend, it is clear we've made progress on this front. And importantly, we've been able to build appropriate inventory levels across the stores and online in time for holiday.

Specifically, the restoration of inventory levels in private brands like St. John's Bay, Stafford, and jcp Home, key to improving sales we saw over the course of the quarter. We also saw significant sales increases in some of our largest national brands such as Levi's, Nike, Carter's, Dockers, Alfred Dunner, Vanity Fair, and IZOD based on the strength of our assortments and the continued success of the shop environment for several of these key brands.

Our success with brands our customers know and love is critical to us. But, at the same time, we are dedicated to bringing in fresh, new merchandise. As an example, during the third quarter, we further enhanced our assortments with new offerings for kids, including Disney, which we launched in early October. And our Disney stores are off to an encouraging start.

We continued building our successful partnership with Sephora, opening 30 new Sephoras inside jcpenney locations in the quarter, bringing our total number of Sephora locations to 446. Of course, we could never be fully stocked in brands and attractions our customers want without our suppliers and vendors, whose support for us remains strong, and, contrary to inaccurate reports, has not wavered over the past several months. We are incredibly grateful for our vendors' partnership and look forward to seeing their business with us grow as we continue to turn the corner in ours.

Now for a quick update on our marketing. While having the right merchandise is enormously important, it's not enough. We need to drive traffic by communicating our value and style proposition in a clear, compelling way.

Our first step has been to insure that our customers know that meaningful promotions are back. We began to see our efforts take hold for back to school, but our recent performance with the Biggest Sale of Them All shows that we have made measurable progress in demonstrating to our customer that if you want great value we're the place to get it.

But promotional marketing isn't enough either, particularly as we enter what's expected to be a fiercely competitive holiday season. Starting this week, you'll see a new, clever marketing campaign that we believe will break through the noise and set us apart from our competitors. I'll discuss our holiday plans a bit more in a moment.

Now, turning to the fixes in our home store, we've been working as quickly as possible to remerchandise and reconfigure the home departments in our stores to better reflect how customers shop, while highlighting our most compelling brands and price points. To start off, our customers wanted and expected our home department to be organized by category and classification as opposed to only by brand, so they can see all of what we offer in a given category and make comparisons and make their decisions.

We tested this shift with terrific results in the second quarter, and since then we've been rolling out the changes nationally. Overall, fixing home has been a challenge. That also means it brings opportunity for improvement and there's upside in this business. And we are pleased we're moving in the right direction.

jcp.com -- we are thrilled to report that jcp.com is performing very well across the board. Sales for the quarter were up 24.5% year over year compared to a negative 2.2% in the second quarter. This improving trend accelerated through the third quarter and we had a 37.6% increase in the month of October.

In addition to home, which represents about half of our online sales, the strongest performing categories online were women's, men's, and children's apparel. In particular, children's benefited from the Company's launch of our Disney concept with toys, role play, and fashion apparel for kids selling extremely well. The success of jcp.com reflects the reintegration of store and online buying, planning and allocation, and improving our merchandise assortment and in-stock levels across sizes and styles. And we have reconfigured many of our user interfaces to make it even easier to shop.

We also know that customer experience is important to our success. During the third quarter, we continued to improve the customer experience in our stores and online in direct response to customer and associate feedback. For instance, we restored the three tiers of our popular JCP Rewards program and relaunched the program this quarter.

The most important ingredient in the customer experience is the quality of the services received. And our associates are delivering on that as never before. The positive energy in our stores is inspiring. And it's a direct result of the strides we're making to bring back our customers. Our associates are feeding off this progress and they are doing everything they can to help us win.

In the third quarter, we achieved the best customer service scores in the Company's history, with significant improvements in friendliness, availability of service, and the cleanliness and visual clarity of our stores, among many other categories. I'm enormously proud of our team, and I want to thank them for all of their hard work and their complete commitment to our success.

Looking ahead, as I mentioned, our sales performance has continued its improvement trajectory thus far in the fourth quarter. And we expect to close the year out with positive comparable store sales for the period. We just launched a new, interruptive and clever marketing campaign this week.

We feel we have the merchandise, marketing, and the associate team in place to compete this holiday season and win more than our fair share. And that's our mindset. For the first time in our history, we'll be opening at 8.00 PM on Thanksgiving day. And we expect the weekend and Cyber Monday to be big opportunities for us in jcp.com.

In summary, we are definitely pleased with the progress being made. And we believe we've turned the corner. At the same time, there's a great deal still to be done. We fixed many of the problems we've been confronted with but others remain and we're working hard to address them.

While our immediate goal has been to get our customer back into our stores, the ultimate goal is to deliver consistent, profitable growth over the long term. We're not there yet, but if we continue gaining traction and building momentum we will get there. I'm confident we have the strategies and people in place to do it.

Now, I'd like to turn it over to Ken who will take you through some of the details of our results for the period.

Ken Hannah - *JC Penney Company, Inc. - CFO*

Thank you, Mike, and good morning, everyone. Welcome to our third-quarter 2013 financial report. As Mike mentioned, our strategies to return to profitable growth are continuing to gain traction. And this became increasingly clear as the quarter progressed.

Our top-line sales and gross margin performance improved sequentially throughout the quarter. In fact, even if you compare back to 2011, sales improved on a two-year basis throughout the quarter. And this two-year improvement accelerated sequentially from this year's second quarter to the third quarter. With that, let's walk through the results.

Total sales for the quarter were $2.779 billion compared to $2.927 billion in the same quarter last year. Comparable store sales decreased 4.8% for the third quarter. This represents a 710-basis-point sequential improvement versus the second quarter this year.

As our turnaround efforts continued to progress, our comp sales improved each month during the quarter, culminating in October for our first positive monthly comparable store sales results in nearly two years. As a point of clarification, our sales are reported on a fiscal-week basis. And our October and third-quarter results are through November 2 this year, compared to October 27 last year, therefore, not reflecting any of the benefits year over year of Hurricane Sandy.

Online sales through jcp.com improved significantly this quarter, contributing $266 million in sales. Online sales for the quarter increased 24.5% from the same period last year. Similar to our overall performance, the online sales trend improved sequentially over second quarter and throughout the third quarter, with the month of October up over 37% to the same period a year ago.

Now, turning back to stores. Our traffic improved sequentially throughout the quarter, yet remains negative when compared to the same period last year. Our store conversion for the quarter was up versus last year, after being down in the prior quarter.

This is due in large part to our efforts focused on restocking basics and private-branded product, the items customers expect to find at JCPenney, as well as the return of key promotional marketing events. This improvement in conversion could not have been achieved without the tireless efforts and great customer service of our motivated associates throughout all of our JCPenney stores.

For the third quarter, gross margin was 29.5% of sales, compared to 32.5% in the same period last year. We were pleased with the progress that resulted in gross margins improving sequentially each month of the quarter. When compared to last year, gross margin was impacted by the aggressive markdowns taken to sell through inventory that wasn't resonating with our core JCPenney customer, and are transitioned back to a promotional pricing strategy in 2013.

We have and continue to restore a compelling mix of private-, exclusive-, and national-brand merchandise that better resonates with our customers, resulting in fewer markdowns at the end of the selling season. As we look forward to Q4, we expect our margins to improve both sequentially and year over year.

Our SG&A expenses were $1.006 billion in the third quarter. That's down $81 million from the same quarter a year ago. The teams continued to do a great job managing expenses throughout the business, with net SG&A savings of approximately $800 million over the last seven quarters. This is in light of our continued investments in marketing and customer service-related activities within our JCPenney stores.

Continuing with operating expenses, primary pension expense was $25 million, down from last year. And, by the way, our pension plan remains fully funded. Real estate and other net was income for the quarter of $27 million, reflecting a gain on the sale of the disposition of two non-core mall partnership interests.

Depreciation and amortization expense was $161 million in the quarter, up $28 million from the third quarter a year ago. This increase is primarily the result of the depreciation from investments made in our existing stores.

We incurred $46 million in restructuring charges during the quarter, $10 million of which was related to store fixtures, $3 million in management transition expenses, and $39 million of other costs, including $36 million related to the return of our shares of Martha Stewart Living Omnimedia previously acquired by the Company, and a $6 million credit in home office and store associated with the reversal of termination benefits that are no longer expected to be paid.

Similar to last quarter you may have noticed that our effective tax rate looks extremely low. Our third-quarter results reflect an effective tax rate of 2.2% compared to 41.7% in the same quarter last year. This lower tax rate and lower associated benefit is primarily driven by a charge of approximately $184 million to record an increase to the tax valuation allowance for deferred tax assets, which is negatively impacting the net loss in the quarter by approximately $0.73 per share. We expect our effective tax rate to be near zero for the remainder of 2013.

Our reporting earnings per share is a loss of $1.94 for the quarter. Adjusted for the charges we took in the quarter for restructuring, the net gain on the sale of non-operating assets, and adding back the pension expense, the adjusted EPS is a loss of $1.81 per share. This $1.81 loss per share does not include the $0.73-per-share impact associated with the tax valuation allowance.

During the quarter the Company enhanced its liquidity through the issuance of 84 million shares of common stock, resulting in net cash proceeds of approximately $786 million. Cash and cash equivalents at the end of the third quarter of 2013 were $1.227 billion, a decrease of $308 million from the end of the second quarter as we invested in seasonal inventory and voluntarily paid down $200 million against our revolving credit facility.

Our merchandise inventory is $3.747 billion at the end of the quarter. As mentioned, we invested $592 million in inventory this quarter, reflecting our typical seasonal build and preparation for holiday, as well as a continuation of our efforts to get back in stock in key basic items and private brands. As Mike stated, our merchandise assortment is outstanding, due in large part to the continued strong support of our domestic and international supplier partners.

Property and equipment is $5.758 billion,(sic - see Press Release "$5.753 billion"). up from $5.493 billion in the third quarter a year ago. This increase is primarily associated with the capital investments that we have been making in our existing stores. Our supplier payables at the end of the quarter were $1.409 billion, down $1 million from the third quarter last year.

The majority of our seasonal inventory build happened in early August ahead of back to school as we increased our basic inventory levels and private-brand stock. Short-term borrowings are $650 million, down from $850 million in the second quarter due to the voluntary repayment of $200 million under the revolving credit facility. This repayment reflects management's increasing confidence in the progress of our turnaround.

Our long-term debt is up $1.98 billion over last year, due to the issuance of a $2.25 billion senior secured term loan facility in the second quarter of this year. Our total net deferred tax assets and liabilities are down $536 million as compared to the same quarter a year ago, due primarily to an increase in deferred tax assets for net operating loss carryforwards, net of the valuation allowances.

Our operating cash flow for the third quarter was a use of $737 million. This reflects a planned increase of $592 million in inventory, which includes restocking of basic and private-branded categories, as well as our typical build of seasonal inventory in preparation for holiday as part of our turnaround strategy. Our capital expenditures in the quarter totaled $161 million, reflecting our investment in additional Sephora inside jcpenney locations, Disney, and a partial paydown of the accrued and unpaid capital expenditures from last quarter.

Financing free cash flow was a source of $557 million, reflecting the net proceeds from the Company's equity raise of $786 million, offset by the voluntary repayment of $200 million against the Company's revolving credit facility. With our third-quarter cash balance of $1.227 billion and the availability under our credit facility, the Company had total liquidity of $1.7 billion at the end of the quarter.

As we look forward into Q4, taking into consideration our anticipated continued improvements in the business, our expectations are for comparable-store sales and gross margins to improve both sequentially and year over year, with our SG&A expenses continuing to trend below last year's levels. Capital expenditures are expected to be approximately $175 million in the fourth quarter, including $102 million that was accrued and unpaid at the end of the third quarter, resulting in depreciation and amortization expense of approximately $165 million for the quarter.

We expect capital expenditures in FY 2014 to be approximately $300 million. Our inventory levels at year end are expected to be approximately $2.850 billion. With these anticipated improvements, total liquidity available to the Company at the end of the year is expected to be in excess of $2 billion.

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

Mike Ullman - *JC Penney Company, Inc. - CEO*

Thank you, Ken. As you know, it's been about seven months since we started the extraordinary turnaround efforts here at JCPenney. On the last several calls, we've identified that we had 30 major issues to address. And I'm pleased to say well over two-thirds of those issues have been addressed.

We have the right strategy, we have the right team, we know what the problems are, we know how to fix them, but it's going to take time. And I should close by saying it's not been easy and we still have a long way to go. But there are unmistakable signs heading into holiday that our turnaround is on course and that we will, in fact, make significant strides to restoring JCPenney to its rightful place in retail.

With that, we'll turn it over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Matthew Boss with JPMorgan.

Matthew Boss - *JPMorgan - Analyst*

Hi, Mike. You've made a lot of changes to the inventory and the mix over the last six months. Inventory out of 4Q -- you're expecting it up over 20%. Can you talk about the composition -- your comfort here? And where is this versus your initial plan?

And then, do you think that you now have the pieces in place to maintain sustainable comps in gross margin going forward?

Mike Ullman - *JC Penney Company, Inc. - CEO*

Yes, great question. We're very happy with our inventory level and the composition of the inventory, I would say, aside from one category, which is obviously the inventory left over from previous assortments and strategies that did not resonate with the customer.

But specifically the biggest piece of the inventory increase is our basics and sizes. We were depleted in those areas, and those happen to be the highest-margin categories. So, we are quite pleased to have that inventory in place. And customers are responding well to finding their size and finding the basics that they were used to seeing in the past.

I would say also, obviously the inventory build for holiday for our promotional strategy is not off our plan. We are at planned levels. So, we're quite happy with the composition and the size of the inventory.

In terms of margins, it's a complicated discussion in the sense that the biggest plus, of course, is restoring the proportion of our inventory in the private-brand category. We have the unique situation where the private brands, which resonate so effectively with our customer, give them the best value but they also give us the best margins. And the previous strategy had depleted a good portion of the private-brand proportion, and we now are very close to the desired level. That and editing out the attractions and concepts that didn't work, we believe, are the biggest upside for the margin going forward.

Having said that, there's still several margin components that are weighing us down. The biggest of which is, of course, the discontinuation of some categories and the negotiating with various partners to getting out of things that didn't resonate with the customer. These are non-recurring. And, frankly, once they are out of the arithmetic of margin, we feel quite confident that and the shortage issue getting back into proper proportion, that we can return to historical margin levels.

The shortage issue is one that we had taken the sensomatic tags, or the senso tags off of some key categories. And, of course, that allowed there to be much more theft than we would like to see. It takes a while to go back and retag these items. Obviously, we have to retag what's on the floor, as well as what's coming in.

So, I would say that, and the fact that getting back into a normal promotional strategy, we had to restore the mark-up levels necessary to be able to fund that. I would like to point out, since there's a lot of people saying that we are, quote-unquote, giving the merchandise away, there's no remarkable difference between the margins we're obtaining on promotional markdowns through our major events than there was in 2011. So, it's just not a fact, and we're quite comfortable with our promotional markdowns promotional strategy.

Matthew Boss - *JPMorgan - Analyst*

Wow, your Biggest Sale of Them All has historically been one of the best promotional events that you've run. Can you talk about the reception in early November? And have you seen traffic levels return to positive territory, so far?

Mike Ullman - *JC Penney Company, Inc. - CEO*

Yes, we've had positive traffic in November. Obviously, we're heading into the real peak levels of promotion over Black Friday, as well as early December. The Biggest Sale of Them All is a promotion we had run for years, once per season. It's very popular with the customers and our associates. It's a great time of excitement in the store, with a number of doorbusters, and a great opportunity to show our merchandise early in the season.

It was very well executed. And because it was over Veterans' Day holiday, we had an extended period of time to be able to work with customers and associates on the event. Our customer service scores, again, were the highest we've seen. And we're very pleased with the event, and I think it bodes well for our ability to execute key promotions for the rest of the season.

Matthew Boss - *JPMorgan - Analyst*

Great, best of luck.

Operator

Brian Nagel with Oppenheimer.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Hi, good morning. My first question -- I wanted to drill down a little bit further into gross margins. If you look at the 300-basis-point year-on-year decline we had here in Q3, that you've telegraphed improving gross margins into the fourth quarter. The first question is -- what share, or what portion of that 300-basis-point decline was directly attributable to still clearing through the old product that did not resonate with your customers?

Mike Ullman - *JC Penney Company, Inc. - CEO*

About two-thirds of the gap.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Okay, two-thirds. And are we clear to say that that product is now gone?

Mike Ullman - *JC Penney Company, Inc. - CEO*

No, I wouldn't say that's a fair characterization. I think we will have about the same amount probably in the fourth quarter, and it will start to decline in the first part of 2014 Spring.

Keep in mind, the home store was a big surprise for us. We really expected home in early June to open up on a positive trend and have things resonate. It did not do so, and some of that clearance persists in the third and fourth quarter, as well as into next year. We believe home in the March time frame will start to be the way we would expect it to have been last June.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Got it. As we think about the puts and takes in the gross margin for the fourth quarter, what impact will the ongoing clearance of that old product have on fourth-quarter gross margins?

Mike Ullman - *JC Penney Company, Inc. - CEO*

I think it's about the same impact in terms of basis points as it was in the third quarter. We'd like it not to be there. I'm not sure in the history of retail anybody has ever taken the entire assortment and changed it while it's still open. And, frankly, it's been very difficult to clear the merchandise that didn't resonate with the customer the first time.

And then, obviously, with our traditional customer coming back, it particularly didn't resonate with that customer. So, it's been difficult, and some of it's had to be sold under cost. So, that's what the deterioration has been.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Got it. As far as -- a couple quick followups -- November sales -- you commented in your prepared remarks and the press release that you were pleased with the start to November. Can you comment further if it represented further acceleration of what we saw in October?

Mike Ullman - *JC Penney Company, Inc. - CEO*

I think it's progressively improving. Obviously, because of the spike in promotional events within the holiday season, it's going to vary by week and by promotion. Also, the calendar is quite different than a year ago. But we're confident that we're on the right track and the customer's responding well.

I think customers only come to department stores 6 to 12 times a year, unlike a weekly shopping experience at a big-box discounter. So, it takes a while for the customer to realize we're back in business, that we have the aesthetic they are looking for, the lifestyle that they are used to, the price promotion that they enjoy.

And as I've said in the past, it's not just high/low across the store. Obviously, Sephora is not a price-driven, promotionally driven business, and it's our most successful thing in the store. Manufacturers' suggested retail pricing is more the norm with our national brands. And the customer expects to shop promotionally with our private-brand merchandise. So, the combination of those three across private brand, national brand, and our attractions and exclusives, that's the arithmetic that gets us back to 37% to 39% gross profit that we had for 7 to 10 years.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Got it. And then, finally, just -- the decision to voluntarily pay down $200 million on your revolver -- why, and from our standpoint, how should we interpret that use of capital?

Mike Ullman - *JC Penney Company, Inc. - CEO*

I'll let Ken answer that. He's right here.

Ken Hannah - *JC Penney Company, Inc. - CFO*

Yes, when we look at the revolver, we had drawn the $850 million. And we felt, with our cash balances well in excess of $1 billion, that it was time to start to look at the capital structure and the amount of interest expense that we're paying. And as our confidence continues to improve, we would like to pay that down. That liquidity is still available to us, should we need it. But felt like it was time to begin reducing that revolving balance.

Brian Nagel - *Oppenheimer & Co. - Analyst*

Got it. Thank you very much.

Operator

Neely Tamminga with Piper Jaffray.

Neely Tamminga - *Piper Jaffray & Co. - Analyst*

Great, good morning. Mike and Ken, I would love to dig a little bit into the comp metrics, specifically the conversion rate. I think from our perspective that was probably one of the more compelling call outs out of the last release, because the conversion rate is improving. Is there any way you could help us contextualize maybe how poor the conversion rate was over the prior management's tenure? And then how much headroom you have left to make that ground back up on the conversion rate?

Mike Ullman - *JC Penney Company, Inc. - CEO*

Conversion rate, as you well know, reflects how much the customer satisfies what they came to shop for. And we are consistently up day after day versus last year on a comparable day. So, we think we're in the blue-sky period, territory, in terms of the conversion rate.

Being in stock and sizes in the basics helps the conversion rate. Finding things that are new and exciting and innovative, and finding the merchandise they came to shop for, is the key to conversion. So, it's been easier to restore the conversion because we've got the inventory back in the store, beginning with back-to-school. It's been harder to keep waiting for the customer that hasn't been back yet to come to the store. But, as we said, with the Biggest Sale of Them All, I think it was probably the first big opportunity.

We probably saw the vast majority of the customers that traditionally shop at JC Penney. In 2011, that was half of the families in America shopped at least once at JC Penney, either online or in a store. So, we have a very big footprint. And we think we're ready to show off the categories that we have in the store, and I think they will be particularly pleased with holiday.

Neely Tamminga - *Piper Jaffray & Co. - Analyst*

Ken or Mike, could you give us a sense in terms of Black Friday last year -- how it performed from a traffic perspective. We're myopically focusing on that as a key traffic day. What sort of runway you have ahead of you in terms of making up some lost ground on the traffic side?

Mike Ullman - *JC Penney Company, Inc. - CEO*

Rather than go back to the specifics, I think it's fair to say we weren't really open for business at some of the key times. So, on Black Friday, for example, we opened at 6 AM, when others opened at Midnight and 4 AM. So, that obviously was detrimental.

Our internet business -- the dot-com site did not perform as well as we would have expected during that period. So, we think we have an opportunity during Black Friday weekend with the 8 PM opening, as well as being ready for prime time with dot-com. Our internet business is quite reassuring.

For one thing, one of the things that we were missing a year ago is we didn't really have the same assortments online as we had in the store. So, it was difficult for a store associate to go online and fulfill a need. If they were buying drapery panels, and they had four in the store and they needed six, they immediately could go online and get the other two shipped to the person's home. I'm pleased to say this year those -- what we call referrals -- those are up 10% over last year at this point.

So, we know that the associates are back to using the internet to help fulfill customer needs. That's quite encouraging during holiday, as we have key items that are in the store and key items online. So, we think we're very well prepared for the Black Friday weekend.

Neely Tamminga - *Piper Jaffray & Co. - Analyst*

We wish you the best of luck. Thank you.

Operator

Lorraine Hutchinson with Bank of America.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Thank you, good morning. I just wanted to follow up on some of the brands that you're discontinuing. You mentioned that you had some receipts still coming in the Spring, but when will we see those discontinued brands completely exit the store?

Mike Ullman - *JC Penney Company, Inc. - CEO*

I think that's a difficult question, because obviously, let's assume there's 10 or 12 ideas that didn't resonate. Some are already gone, others we have commitments going forward for shipments that are not yet there.

I would say that rather than get into specifics, the things that are working really well -- Sephora, MNG by Mango, Call It Spring, Modern Bride, Liz Claiborne, Disney -- these are things that the customer's finding, and really that's resonating. And we're trying to clear the rest as expeditiously as possible without doing things that don't make sense.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

And then, some of these brands had shops built for them. As you think about next year's CapEx guidance of $300 million, does that include any restructuring of the store to make those changes? And is there upside risk to that $300 million because of this brand discontinuation?

Mike Ullman - *JC Penney Company, Inc. - CEO*

I'm pleased to say that we really didn't build any custom shops of any magnitude. And while we have some -- probably little renovation issues, they won't be major capital involved. The shops in the home store will be repurposed, in some cases, to have better classification statements, whether it's in soft home or frames and gifts.

But we listen pretty carefully to the customer. The customer will tell us exactly what they want in the store, and they'll be able to help us where it should be displayed. So, you'll start to see, as I said, over the next four or five months the home store is going to get back in a place where it's not only going to be easier to shop, but I think we have the best-looking home store in our space. So, we're eager to relaunch that when we're ready for prime time.

But I don't see any major CapEx dedicated to tearing anything apart. We have some minor things in terms of repositioning some merchandise, but that will be managed in the first quarter.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Thank you.

Operator

Bernard Sosnick with Gilford Securities.

Bernard Sosnick - *Gilford Securities - Analyst*

Good morning, and congratulations on what you've accomplished so far.

With regard to the clearances, you indicated that there might be about 200 basis points of clearance in the fourth quarter, similar to what you experienced in the third quarter. Could you give us a clue perhaps as to what you think clearances would be versus a year ago, given the steep dive in the gross margin last year and the tremendous amount of clearances?

Mike Ullman - *JC Penney Company, Inc. - CEO*

What I'm referring to, Bernie, is the clearance that we think will be non-recurring. There's always clearance in terms of buying and selling merchandise in the price cycle of regular price, promotional price, and clearance price. You're right -- a year ago, particularly in the month of January, we had extraordinary clearance to sell things that didn't sell during that period of time. But what we're trying to sort out here are the issues that aren't going forward.

So, it's hard to compare a lot of things precisely to 2012. It's a completely different strategy. So, we always look back at 2011 to try to find a compass as to what it should be for promotional versus clearance. So, I'm just trying to share with you that it's probably about the same impact to margin for fourth quarter as it was in third quarter.

Bernard Sosnick - *Gilford Securities - Analyst*

Okay. And of the inventory increase, much of it was for rebuilding in the way that you wish to see the assortment look. And you're almost there. And some of it includes inventory that perhaps you wish wasn't there. How much would you say the inventory increase has been for the goods to improve the assortment and get it the right way, and how much might be excess?

Mike Ullman - *JC Penney Company, Inc. - CEO*

It would be an estimate, Bernie, but I'd say two-thirds of the increase is in exactly the categories we'd expect to be there, maybe there's a third of that couple hundred basis points that is in the discontinuing and moving-it-out category. Non-recurring is maybe a better way of saying it than discontinued.

Bernard Sosnick - *Gilford Securities - Analyst*

Okay. And the increase in the recurring inventory, the ones that you wish to have, would be in line with your expectations for sales, and you'd come out of the quarter with inventories pretty much in line at the end of the quarter. Meaning that you're giving us a clue as to what your expectations are for sales.

Mike Ullman - *JC Penney Company, Inc. - CEO*

Yes, we obviously plan the quarter to be positive in terms of sales. We're going to have inventory at the end of the season that is ready for prime time for Spring. We did not have sufficient basics and sizes at the end of fiscal 2012, so you'll see that continue in the inventory. And that's the most productive in terms of gross profit of any inventory we carry.

So, we actually have no basic concerns about the condition or the size of our inventory. We're quite comfortable. As a matter of fact, in our forecast meeting with all of our divisional merchants, I think across the board everybody feels they have the right inventory for holiday and for getting ready for Spring.

Bernard Sosnick - *Gilford Securities - Analyst*

As far as marketing, you said the campaign is going to begin within days. But there was also the beginning of the big promotional event for Veterans' Day weekend and Black Friday. Aside from the Veterans' Day and Black Friday, what do you have in terms of the cadence of promotions versus a year ago, and your share of voice as you get out there and market?

Mike Ullman - *JC Penney Company, Inc. - CEO*

I think it's a fair question, but it's almost impossible to answer it versus a year ago because we didn't have a promotional strategy. So, we tried a few things that didn't work. If we look back at the cadence of 2011, we have the necessary promotion and share of voice that we think to compete head to head with our key competitors. We know it's going to be promotional in all aspects.

Having said that, as in our release, we've invested in an innovative and disruptive and quite family-oriented marketing campaign that talks really about what mom has on her plate in getting ready for Christmas and the holidays. So, it's already started running. I believe it started on Tuesday. There will be four or five different versions of it throughout the season, including a Latino version, which we're very excited about.

So, we believe we've worked very hard. And Debra Berman and her team have been working since August to get the right balance between a strong promotional story that makes it clear to the customer we have what they want, that competes head to head with our competition. But also leaves them with the idea that JC Penney is the place they should shop because we have the values, and we have the people and the service that they won't find elsewhere.

Operator

David Glick with Buckingham.

David Glick - *Buckingham Research Group - Analyst*

Thank you. Mike, just a question -- a followup on home. Obviously, that was a big turnaround in the month of October. Historically it's been 20% of your Business. It sounds like it was down to about 10%.

I'm just wondering if you can give us some idea or vision of how you're going to utilize the remodeled space in those four feature shops, for example. And how you see the balance from a brand, and a soft versus hard home perspective, so we can visualize what 2014 might look like for the home area, which I know is a key traffic-driving area of the store.

Mike Ullman - *JC Penney Company, Inc. - CEO*

David, thank you. There are about 10 different initiatives in home. I'll just click them off for you.

First of all, we needed to balance the lifestyle mix. We had a little bit too less -- we didn't have enough traditional lifestyle. We had a bit too much modern. That's underway. That will be in place for Spring season.

Second, we didn't have enough opening price-point merchandise -- almost too much skewed toward better and best categories. Third, we were a little bit out of line in terms of the amount of hard home versus soft, as you point out. So, we're restoring the balance between soft and hard, which is about 50/50 in our go-forward plan.

We also are doing a much better job of identifying classifications of key items. Customers love to shop for home, but they need to understand what's new, what's a great value, what's good-better-best by category. That was blurred and very difficult to really understand as you walked the store.

I think we also are respacing some of the key businesses. We are the number one soft window retailer in America. And we, unfortunately, had reduced the space for that category. Luggage, another very profitable and key category, was underspaced. We think the frame business, the candle business, and the gifting business, those businesses are opportunities.

So, as to the shops, we're obviously modifying the shop presentations based on what the customer is responding to. So, Jonathan Adler and Michael Graves, and some of the things that are really quite unique and quite special, we'll have a opportunity during holiday to see if those giftable items really resonate. And we'll modify our behavior based on what the customer is telling us.

But we're excited about home. Probably the most encouraging thing is home is doing extremely well online. Where obviously the store structure and some of the difficulties we're having in our 500 new home stores isn't reflected in the way you shop it online. So, the online business is quite strong. And if we just get to the level of activity we're getting on home when we relaunch in March, we'll be very, very satisfied that we have the best trending home business in our space.

David Glick - *Buckingham Research Group - Analyst*

Great. Thanks for that detail, Mike. I just had a followup for Ken on gross margin. I'm just wondering -- at this point do you have your IMU where it would like to be? Or is there further progress to make?

And as we think about your gross margin, is the real opportunity when you come up against those clearance periods a year ago, when your, quote-unquote, regular price sell-throughs were deficient, and you had to sell a much greater percentage at clearance prices than perhaps you may this year? Is it really that late December, January, February -- is that really an opportunity time frame from a gross-margin perspective?

Ken Hannah - *JC Penney Company, Inc. - CFO*

When you look at -- your first question on IMUs -- the teams have made a lot of progress. We're still looking at opportunities to make sure, based on the level of promotional activity that's going on in the marketplace, that we've got the IMUs. As Mike mentioned before, when we look at our regular and sale business, and compare back to the 2011 periods, we're seeing selling margins there that are comparable.

So, when you really break down our gross margin, it is the clearance. We've seen an improvement in the mix of clearance. And we saw that improve throughout the quarter. But the rate in which we're required to clear the goods that aren't resonating is what has put the pressure on the margin.

David Glick - *Buckingham Research Group - Analyst*

Right. And then just last, Ken, as you look at the last seven quarters, obviously significantly negative EBITDA. It appears that your guidance might suggest the first break-even EBITDA quarter in Q4. Is that a reasonable assumption based on how you're modeling your Business?

Ken Hannah - *JC Penney Company, Inc. - CFO*

We're not ready to provide that level of detail. I think as we come out of third quarter and go into fourth, obviously we're seeing traction, and we're seeing things move in the right direction.

Obviously, over the next couple weeks we're going to get a much better sense in terms of what the trajectory is of that line. And then, hopefully Mike and I will be in a position, when we report fourth quarter, to start getting a little more specific around 2014 and EBITDA and those types of numbers. But I think right now we're comfortable that everything is moving in the right direction, and anxious to see the trajectory of that through the holiday.

David Glick - *Buckingham Research Group - Analyst*

Thank you very much. Good luck.

Operator

Will Frohnhoefer with BTIG.

Will Frohnhoefer - *BTIG - Analyst*

Hi, guys. Just a couple questions. Number one -- just to circle with Ken on the revolver again. So, you guys paid that down, as you said, largely to reduce interest expense to basically manage the balance sheet a little bit more efficiently.

You still have the same amount of availability that would have been available otherwise. It's about $500 million or so, as disclosed in the press release. I'm wondering whether or not you guys have looked to expand availability or you're satisfied with the liquidity position you've laid out for the fourth quarter?

Ken Hannah - *JC Penney Company, Inc. - CFO*

I think we're satisfied with the liquidity position that we've laid out for the fourth quarter.

Will Frohnhoefer - *BTIG - Analyst*

Okay. And then, to sharpen it up a little bit there on the inventory, you had mentioned that roughly one-third of that inventory build was based on inventory -- on goods that you guys believe would need to be sold through as opposed to being part of the more permanent merchandise selection you have. And that would come out to roughly about $200 million. I'm wondering if that's the number, as well, that we would look for going through up till March when I think you guys indicated your merchandise selection in home would be balanced correctly.

Mike Ullman - *JC Penney Company, Inc. - CEO*

Just to clarify, I think the proper way to think about this -- we have the same amount of non-recurring inventory effect in the fourth quarter as we had in the third quarter. And a diminishing portion in the first quarter of next year.

Will Frohnhoefer - *BTIG - Analyst*

Okay, very good.

Mike Ullman - *JC Penney Company, Inc. - CEO*

And we expect by March not to have that as an issue to be concerned about.

There's always going to be clearance when you're buying and selling merchandise across 40 different businesses. But what we're talking about now is something that you wouldn't expect to have in a business unless all of a sudden you were going 60 miles an hour one direction and you turn around and go 60 miles an hour the other direction. There's some dislocation in that turnaround.

It's persisted longer than we would have expected because the home store was a big surprise. We didn't really -- when we planned the Fall season, we really didn't see home as not contributing. As a matter of fact, we intended to have that be a plus as opposed to something that's been difficult to manage.

Will Frohnhoefer - *BTIG - Analyst*

Very good. Thank you very much.

Operator

Dana Telsey with Telsey Advisory Group.

Dana Telsey - *Telsey Advisory Group - Analyst*

Good morning, everyone. As you think about the marketing for this holiday season, how are you thinking about post Christmas in the marketing this year versus last year?

And when you think about the categories, particularly on the apparel categories -- basics and some of the other items -- are you seeing different gross margins on them? And are you adjusting pricing? What should we be looking for? Thank you.

Mike Ullman - *JC Penney Company, Inc. - CEO*

Dana, thank you. I think the best way to think about it is -- if you go back to a traditional cadence of previous years, it would be much more instructive to look at that as opposed to last year. First of all, I wasn't here last year, so I can't be specific about what it looked like. But the season didn't go well, being down 32% in sales. So, some rather difficult decisions had to be made in terms of getting ready for Spring.

We don't have those same issues, and we feel very good about being ready for Spring season. Our forecast method here, dealing with every one of the merchant teams, everybody feels good that we would be prepared for Spring, that we'll work through the inventory that we need to work through.

For holiday, we feel that we planned holiday correctly. So, while it might look strange about the inventory coming into the fourth quarter, that's comparing it to a very different cadence of a year ago. And, frankly, they were not in business in some of the key categories, like sizes and basics. And they didn't have a promotional cadence to deal with either. So, I guess the good news is we have strong teams, strong leaders, and they know exactly what they're doing, and I'm confident that we'll deliver the plan.

Dana Telsey - *Telsey Advisory Group - Analyst*

Thank you.

Operator

Liz Dunn with Macquarie.

Liz Dunn - *Macquarie Research - Analyst*

Hi, thanks for taking my question. Just a few follow-up questions. In terms of the inventory, looking at this third quarter versus the third quarter of 2011, you're still decently below that level. So, will we get back to 2011 levels? Or has there been some permanent flood of inventory that's been removed?

Mike Ullman - *JC Penney Company, Inc. - CEO*

I think that's a very good question. I think, obviously if you lose $4.5 billion worth of volume, you wouldn't immediately go back and put all of the inventory back to -- do $4.5 billion more. So, we have to earn it back. The good news is the customer seems to be more than willing to help us do that. But we are not going to plan the inventory ahead of what we see on the horizon in terms of sales during the resurgence.

The good news is I think our teams are feeling it. Their supplier partners are feeling it. Our associates at the store level are really excited about the fact they see customers they haven't seen for a while. And we're consistently getting feedback that our stores look as good as they've ever looked.

So, I think inventory is not an issue for us. Inventory is an opportunity, not a problem. We can easily get more inventory as the trend starts to return.

The real question in retail, as you well know, is -- if you overplan the sales, you end up having too high an expense and too much inventory. If you're a bit cautious with the plan, you can always find a way to leverage the expense and to find additional volume by selling more regular priced and promotional priced, and less at clearance. Those are time-true approaches to running a retail business.

And, needless to say, the difficulties of the turn-around period is we've had not a lot of comparability. So, almost anything you look at against last year's metrics -- very difficult to learn much from that. So, you have to keep going back to what makes the most sense going forward as we earn back the business.

But, clearly, our expense structure is lower, our expenses are under plan, our inventory is where we want it to be. Our teams are motivated and ready to go for the holiday season. Our suppliers are more than eager to help us when we ask for help. I think our presentation of national brands have never been better. So, we're quite confident that we're headed the right direction.

But I always caution that there's still more to do. This is maybe an unprecedented retail re-engineering and construction process. We're quite confident we'll complete it successfully.

Liz Dunn - *Macquarie Research - Analyst*

Okay. And then just finally on margins -- I know you said that the clearance margin was similar to last year and the mix had improved. So, are we to assume that the balance of the deterioration was in just the full price and promotional margins? Can you talk to that maybe a little bit, Ken?

Mike Ullman - *JC Penney Company, Inc. - CEO*

Just before Ken does, I want to make sure I'm correct in what I heard you say. Just to go back through what exactly you mentioned. First, the gross profit and gross margins on new inventory -- selling of new inventory -- private brand is back to the levels we think is necessary to restore margins. National brand margins are where they expect to be to restore margins. And the attractions and exclusives are being edited in such a way that they contribute more materially to our margins.

So, the top-line part of margin, the pluses, are all in place. The negatives are the non-recurring merchandise that we talked about being in the third quarter, the fourth quarter, and a bit of it in the first quarter of next year.

The shortage hit, which, let's assume it's about 100 basis points, this is the result of actions that takes the security devices and security measures off of the inventory at a time when obviously then others that have those devices, most of the theft comes to our place. So, the key categories are being returned in terms of tagging.

The promotional markdown issue is not a problem at this point. It was a transitional issue as we managed the markup to allow for the necessary markdowns during the key promotions. So, it's not something that's recurring. The markup is now at planned levels. So, that is not something that we are overly concerned about.

Those are the challenges. There's no other hidden component of gross margin. And that's why we're so confident about the fact that they will return to our traditional levels.

Anything you compare against last year on that topic is very difficult to calculate because there was virtually no promotional portion. And the rest of the components had been altered in terms of proportion of private brand versus exclusives and attractions and national brand. So, I just wanted to clarify that.

Liz Dunn - *Macquarie Research - Analyst*

All right. That's very helpful, thank you.

Operator

Ladies and gentlemen, this concludes our question-and-answer session. I would now like to turn the call back over to Mr. Mike Ullman, Chief Executive Officer, for closing remarks.

Mike Ullman - *JC Penney Company, Inc. - CEO*

Thank you for joining the call. Obviously, you can tell from the tone and the substance of what we're doing that we're excited to be seeing the final lap of our turn-around process. We think we still have a lot to accomplish.

As I said from the beginning, we know what the problems are, we know how to fix them, and we have the team to do that. And probably are most encouraged by our 110,000-plus associates that are quite eager to get at the holiday season, and see customers and share with them what we have in store. So, thank you very much for joining the call.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.