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JCP - Q1 2017 J C Penney Company Inc Earnings Call

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PRESENTATION

Operator

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

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

Trent Kruse

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

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Also supplemental reference slides are available on our Investor Relations website. While management will not be speaking directly to the slides, these slides are meant to facilitate your review of the company's results and to be used as a reference document following the call.

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

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

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

Thank you, Trent. Good morning, everyone.

For Q1, we delivered sales comp down 3.5%. This disappointing top line result was, in large part, due to a very difficult month of February. Although we're less than pleased with the overall top line sales results for the first quarter, we were encouraged by the positive comp performance achieved in April. Our comp performance through the 9-week March and April period improved approximately 600 basis points versus February.

In our earlier earnings release, we announced our plans to maintain our annual guidance of down 1% to up 1%. This decision was based on the Q4 to Q1 sales improvements in Women's Apparel, which we'll discuss more in a moment, the company's positive comp performance in April and our investments in Sephora and our home refresh categories, including appliances.

As we celebrate our 115-year anniversary as a company, I'd like to thank our associates at all levels for their hard work and commitment in the first quarter this year.

Now I'd like to briefly summarize a few of the financial results from the first quarter. While the quarter proved to be challenging on the top line, we continue to make great progress on improving the company's financial condition. Ed will discuss this in more detail in a moment.

Now let me discuss our all-important apparel business. As you know, it is critical for us to improve the performance of the apparel segment of our business. And although our overall apparel business struggled in the first quarter, we were encouraged by the strong customer response to our now trending items in Women's, and we're pleased with our sales performance in active apparel and our dress business.

Improvements in these apparel categories bode well for the balance of 2017 as these items become a much larger piece of our business moving forward. Even in the face of difficult top line for the first quarter, our new growth initiatives delivered another quarter of strong performance and positive comps, particularly appliances, in-home custom window, mattresses, furniture, Sephora, Salon, activewear and Fine Jewelry. All of these businesses are expected to deliver even greater benefits for the remainder of 2017.

In addition, we recently held grand openings with 16 new Sephora locations in May with plans to open another 16 Sephora locations in the month of June.

We're also in the process of rolling out 100 new appliance showrooms this month as well as rebranding an additional 50 of our salons to salon by InStyle.

Fine Jewelry had a strong quarter delivering positive comps. Our Fine Jewelry performance is a classic example of great alignment between the merchants and the stores. The merchants have done an outstanding job of selecting inspiring product at a value, and the store team delivered outstanding product knowledge training and customer engagement.

Now let's discuss in more detail the results of the first quarter sales and gross margin performance. All apparel categories, Men's, Kid's and Women's, performed below the company comp for the quarter. Although sales in Women's Apparel remained challenged throughout most of the quarter, it did deliver much improved results in the combined March and April periods versus February.



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Women's Apparel also delivered the best comp trend improvement from Q4 of last year to Q1. Broadly speaking, we're pleased that our new apparel strategy, highlighting inspiring trends at a value, performed well in the casual and contemporary categories of women. Now we must build on this success in the entire Women's division and expand the same philosophy and process to Kid's and other apparel areas.

We're also pleased with our gross margin performance for the first quarter. Although we faced gross margin pressure from continued growth in dot-com and our 500 appliance showrooms, we're able to deliver a 10 basis points improvement in gross margin.

Admittedly, we have a lot of work to do to deliver sustained gross margin improvement for the balance of 2017. However, this gives us confidence that our focus on pricing analytics, store operations, supply chain, merchandising systems are beginning to reap benefits for the company.

With that, let me turn it over to Ed to provide more detail on the first quarter, our balance sheet and capital market activities.

Edward J. Record - J. C. Penney Company, Inc. - CFO and EVP

Thank you, Marvin, and good morning, everyone. As Marvin said, first quarter proved challenging on the top line, but we continue to improve the company's financial condition through significant debt retirement, selling our Buena Park distribution center and our recently announced tender offers.

I plan to cover our first quarter results and discuss the financial opportunities we have in 2017. I'll recap what we achieved in the capital markets this quarter and discuss our initiatives to further improve our financial condition by deleveraging our debt position. And I'll end with a review of our first quarter balance sheet and our financial guidance for 2017, which we reaffirmed earlier this morning.

Turning to the first quarter results. Comparable store sales declined 3.5% for the first quarter. For the combined March and April periods, comp sales improved significantly versus February. Units per transaction and average unit retail were up versus last year's first quarter, while transaction counts were down. Geographically, the Southwest and Southeast were our best-performing regions of the country, and the North East was our worst-performing region. Gross margin for the first quarter was 36.3% of sales, an increase of 10 basis points compared to the same period last year.

Gross margin was positively impacted by improved selling margins for the quarter, partially offset by the continued growth of the company's online and major appliance businesses. We have considerable gross margin opportunities in 2017, and we are well underway with many of the initiatives we laid out in our last call. We are already seeing benefits in such areas as pricing analytics, modernizing our replenishment processes and systems and improving the profitability of our private brands through design, sourcing and speed-to-market initiatives.

We continue to optimize our supply chain network, including the recent sale and future relocation of our Buena Park supply chain facility. Also in conjunction with 138 store closures, we plan to close our Lakeland, Florida distribution center and redirect residual operations to our Atlanta facility. We expect these gross margin initiatives will enable us to offset the expected pressures from our growing appliances and online businesses, and drive gross margin into the guided range of up 20 to 40 basis points for the year.

Moving now to expenses. SG&A expenses for the quarter declined \$29 million compared to the same period last year. The savings were primarily driven by marketing, store controllable costs and incentive compensation. As a percentage of sales, SG&A expenses delevered 20 basis points.

For the first quarter, we drove 170 basis point improvement in our private label credit penetration to 40.4%. We continue to make progress driving our credit penetration, and we expect to end the year with a penetration rate of approximately 42%.

As a reminder, we will start the liquidation process later this month for the majority of the 138 stores we previously announced that's closing. We expect approximately an 80 basis point impact to our gross margin in the second quarter as we liquidate these locations. This expectation is included in our gross margin guidance for the year. As expected, we recorded approximately \$96 million in asset impairment and severance-related charges during the first quarter associated with these store closures.



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In addition, we expect to record an estimated \$65 million in charges, primarily associated with the present value of the remaining lease obligations on these stores later this year, with the majority of these charges being recorded in the third quarter.

While our overall sales results for the quarter were below our expectations, our performance improved in the combined March and April period versus February, and we continue to effectively manage the business by delivering improved gross margins and maintaining our focus on expense management.

Let's now turn to our liquidity position and capital structure. We are very pleased with the recent upgrade from S&P who raised our credit rating one notch to B+ and confirmed our positive outlook. Clearly, this upgrade demonstrates the credit rating agencies continue to recognize the progress we've made with our deleveraging effort and the strategic initiatives we have in place to continue driving sustainable growth and profitability and improve our overall financial condition.

In Q1, we completed the sale of our Buena Park distribution facility for a net sales price of approximately \$131 million. The sale of this facility resulted in a gain of approximately \$111 million in the first quarter.

Looking at our debt reduction initiatives. Since the start of the year, we continue to improve our capital structure by strengthening our balance sheet through significant debt reductions. In April, we utilized available cash on hand to retire at maturity approximately \$220 million of the 2017 outstanding borrowings, which lowered our annualized interest expense by approximately \$17 million.

Additionally, and as previously announced earlier this week, we launched cash tender offers to purchase up to \$300 million aggregate principal amount of 2 outstanding series of securities. A cap has been placed on the 2018 outstanding borrowings to tender up to \$75 million in principal with the balance of the tender offer focused on the outstanding borrowings due in 2019. The retirement of these bonds is expected to contribute annualized interest expense savings of approximately \$23 million. We will be utilizing the proceeds received from the sale of the home office last year to primarily fund the tender offer.

Given our debt reduction initiatives, we expect our 2017 net debt to EBITDA ratio to be approximately 3x by the end of this year. This is down from 3.7x at the end of 2016 and 5.4x at the end of 2015.

Let's move now to cash and inventory. As I stated earlier, we're using cash on hand to retire \$220 million of bonds that matured in April. We ended the first quarter with approximately \$363 million of cash and cash equivalents, and no outstanding borrowings under our ABL. As such, our liquidity position at the end of the quarter was approximately \$2.4 billion. Capital expenditures net of landlord allowances in the quarter were \$75 million, an increase of \$39 million over the first quarter last year.

During the first quarter, free cash flow was the use of \$293 million, an improvement of \$128 million versus the same period last year. As a reminder, we continue to expect to generate between \$300 million and \$400 million in free cash flow in 2017. This full year range includes the expected cash impacts from our store closings and charges related to our Voluntary Early Retirement Program as well as expected proceeds from the sale of operating assets.

Inventory at the end of the first quarter was \$2,949,000,000, up 0.8% from last year's first quarter and was in line with our expectations. Approximately 300 basis points of the increase was driven by inventory investments and 4 samples for major appliance showrooms and higher inventory levels to support our continued investment in new Sephora shops.

We are prudently managing our inventory levels and are pleased with the progress we've made this quarter. Our teams remain committed to reducing inventory levels where appropriate throughout the remainder of this year, and we expect total inventory at the end of 2017 to be down at least 5% versus the end of 2016.

Merchandise accounts payable was \$893 million, down \$102 million from the end of the first quarter last year. The decline was primarily due to reduced purchases in the first quarter.



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We have reaffirmed our financial guidance for the full year 2017. As a reminder, 2017 is a 53-week year, the impact of which has been incorporated into our guidance. We expect the 53rd week is worth approximately 120 basis points on total sales, while comparable store sales on a 52-week basis.

In addition, the following guidance incorporates the impact of our store closures discussed earlier. For fiscal 2017, comparable store sales are expected to be down 1% to up 1%. Gross margin is expected to be up 20 to 40 basis points versus last year. SG&A dollars are expected to be down 1% to 2% versus last year. And adjusted earnings per share are expected to be in the range of \$0.40 to \$0.65.

In closing, although we faced a tough top line this quarter given the challenging environment, we continue to manage the business well through executing our gross margin opportunities, exercising SG&A discipline, controlling inventory levels and deleveraging our debt position. Our teams remain committed to delivering on our 2017 full year guidance.

With that, I'd like to now turn the call back over to Marvin.

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

Okay. Thank you, Ed. And while we remain focused on our strategic framework of private brands, omnichannel and increasing revenue per customer, I'd like to discuss the key growth initiatives that give us confidence in our 2017 financial plan.

First, our beauty category has continued to deliver significant comp growth. The key component of our beauty strategy is our best-in-class partnership with Sephora. As a reminder, we currently operate 588 Sephora inside JCPenney shop and will open 70 new locations in 2017, ending the year with nearly 650 locations. At that time, we'll have Sephora shops in approximately 75% of our stores. Year-to-date, we're also expanding 24 existing Sephora, growing each location by nearly 50% to accommodate more products and client services. We're hiring over 800 beauty consultants in 2017 who are a key component of our Sephora inside JCPenney experience.

Another component of our beauty strategy is Salon. JCPenney Salon business once again drove positive comps for the quarter, and we continue to see benefits from rebranding to Salon by InStyle. We recently announced plans to rebrand 50 more of our salons to InStyle, and hire nearly 4,000 skilled stylist who'll help us to create even more reasons for customers who visit our improved salons. Our Salon customers shop our stores over 8x a year, so we see Salon as a tremendous customer acquisition strategy. The unique experience is a way to create for our customers in-store through our Salon and our Sephora growth initiatives are hard to replicate online and magnify the importance of a physical store.

Second, our home refresh initiatives continue to provide strong results. We delivered positive comps in our home division for the first quarter.

Appliance sales, both in store and online, continue to drive significant comp sales growth and improved productivity in our home store. We added new higher-margin [take-with] categories in our appliance department, such as microwaves and mini refrigerators as we continue to round out our assortment. We're also leveraging this performance by opening approximately 100 new appliance showrooms in the second quarter and adding new brand partners to the showroom throughout 2017.

As some of you may have read and seen, we're conducting several tests within our home store focus on home services programs. With the resurgence of the housing market, consumers are spending over \$300 billion annually to upgrade their homes since nearly 2/3 of the nation's homes are over 30 years old. The programs we're testing will provide turnkey services for heating and cooling systems, simple bathroom remodels, home water treatment systems and quick ship and install brands -- blinds.

Look, we understand that we'll never be #1 in market share in these categories. However, with 70% of customers being female, and over 70% of customers owning homes, we feel it's prudent for us to try to position ourselves to gain a piece of the \$300 billion market opportunity.

And third, we remain committed to becoming a world-class omnichannel retailer. We continue to see significant increase in our online SKU growth and we plan to continue the SKU expansion throughout 2017. We're also expanding our ship from store fulfillment strategy from approximately 250 stores today to 100% of our store network. This means that approximately 875 stores will have the ability to fulfill online orders, which will



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nearly quadruple the available inventory for sale online. This will also significantly expand the fulfillment capacity of our company and reduce the last mile cost of online fulfillment. We're launching this new process in the second quarter.

Our investments and our focus on omnichannel are working. Throughout 2016, approximately 77% of all online orders touched the physical store and this number continued to grow in the first quarter. So as we improve site functionality, enhance our ship from store capabilities and develop a much improved mobile app, we continue to drive increased online revenue in 2017.

And lastly, we'll continue to improve and strategically adjust our apparel categories. Areas where we're excited to see improvements in 2017 are: number one, activewear for the entire family. As previously announced, we're enhancing our partnership with Nike by leveraging over 600 new Nike store environments to offer a vastly improved assortment of apparel, accessories, footwear across all divisions. We're also expanding one of the hottest brands right now, adidas. We added women's adidas apparel to 100 stores in March margins and saw a much improved sales. And we're excited to expand this adidas presentation to over 400 stores by back-to-school.

Footwear will also be a focus for us in 2017. We transitioned to the open-sell concept in 2015 in only 375 of our women's shoe areas. Given the outstanding performance of the open-sell environment, we're in the process of converting all women's shoe areas to open-sell fixtures this year. We're also introducing new styles and comfort features in order to seize available market share in Footwear.

In closing, my optimism on the future of JCPenney is, in large part, due to the fact that we're still playing catch-up to many of our competitors. As we improve our in-store environment and modernize systems, like pricing and omnichannel, we see immediate benefits. Therefore, we know the upside for profit and revenue exist. We simply have to move faster.

In addition, we believe we've developed a series of very specific growth initiatives to serve the needs of our value-oriented customer and provides us with differentiation from our traditional competitors.

And with that, Kaylee, we'll open the line for questions.

QUESTIONS AND ANSWERS

Operator

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

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

Just wanted to get a little bit more clarification on category performance, Marvin. You discussed Women's apparel showcasing some sequential improvement. What specifically was the comp performance of Women's Apparel? And how are stores with appliances performing versus stores without it?

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

So Paul, our optimism on Women's Apparel really stems to the performance of the casual and contemporary categories. That was a tough business for us last year. And we had a spring launch with now trending concept that really resonated well with our customers extremely well. And in many cases, we sold out a product, and we're now reordering for additional launches in the summer. So John Tighe, our Chief Merchant is here in the room, so I'm going to let John provide a little bit more color on why we're excited about those specific categories in Women's Apparel. Relative to appliances, appliance stores performed better because appliances had a significant impact to the overall comp. The good news for us is that Q1 is our lowest appliance-penetrated month. So we're going to see almost double the comp impact of appliances going into the second quarter because



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of patriotic holidays. So we remain very excited about appliances. But I'm going to let John talk to you about the optimism of our spring launch and why we think it's going to help us to get these categories online for summer as well. John?

John James Tighe - *J. C. Penney Company, Inc. - Chief Merchant and EVP*

This is John Tighe, the Chief Merchant. As we move into March, we really leveraged the design capabilities of our talented organization of product development and design, and leveraged their international sourcing to deliver great trends at a great value. And the customer really responded. It was a terrific alignment with the stores organization, with the market organization and the merchants to pull this together. And really, it moved the performance of Women's Apparel and improved half of the loss we had in the fourth quarter. It was an improvement from March and April. So we are excited to expand that and use that as our future model for success in expanding it, not just in Women's Apparel, but around the rest of the store.

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

And just want to also get clarification on EBITDA guidance for this year. You're reiterating the \$1.1 billion. And is there any additional real estate or asset sales that are to be included in that?

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Paul, this is Ed. I'll take that. Well, technically, we haven't given EBITDA guidance, but it's implicit in our EPS guidance. And as we said in fourth quarter that the midpoint is about a \$1.1 billion EBITDA. We also stated we expected sales of operating assets to be north of \$100 million. Obviously, the Buena Park was at \$111 million, so that came in at the high end of our range. We're still working on a few other transactions, probably one significant one that'll close in the fourth quarter. So we think there's upside to that sale of operating asset estimate we gave. We're not upping our guidance right now. Obviously, we just had a very challenging quarter in a challenging environment. But our hope is that some of that flows through as upside as we get through the year.

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

And last one, very quickly, Marvin, are you willing to comment at all about trends more recently over the last few weeks? And how you're kicking off the second quarter?

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

Paul, we try not to get into inter-quarter updates. But what I will tell you is that the fact that we're holding our annual guidance as a reflection that we have confidence that the initiatives that we've talked about are starting to reap some of the dividends that we hold. And more importantly, we talked in the prepared comments about our margin improvement. And although 10 basis points may not appear to be significant, when you factor in that we are going against 500 new appliance showrooms and pretty rapid dot-com growth, which are margin rate dilutive, the fact that we can deliver 10 basis points of improvement, while having significant reductions in inventory, gives us confidence that some of the pricing analytics and supply chain improvements and store operations merchandising systems are paying off. So although I won't give you some specifics on how we're trending this quarter, we'll tell you that we're confident that our initiatives will allow us to have a successful year.

Operator

Our next question comes from the line of Jeff Van Sinderen with B. Riley.



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Jeffrey Wallin Van Sinderen - *B. Riley & Co., LLC, Research Division - Senior Analyst*

Just had kind of a follow-up on apparel to start with. Maybe you can talk a little bit more about what you're doing to drive sustainable improvement in the private label part of Women's Apparel, particularly in terms of speed-to-market. And then also if you could touch on inventory in apparel at the end of the quarter, how you're planning to manage inventory in apparel into Q2 and Q3. And then also separately, if you could speak a little bit about how you're thinking about monetizing additional real estate and what we should expect over the next year or so in terms of real estate sales or sale leasebacks.

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

Okay. Jeff, I'll take the first part of the Women's Apparel question and then I'll hand it back to our Chief Merchant, John Tighe, to provide some additional color. One of the first things that we had to do was really accelerate the design, sourcing to sales floor part of our business for private brands. And we're pleased with the improvements we made in gross margin in private brands. And we're also pleased with the fact that for a large percent of our private brands, we actually cut 40% of the supply chain timeouts, so meaning that we're able to get these goods from design to the physical sales floor 40% faster. And that was driven by great partnership with the merchants, the supply chain sourcing team, the design team and the stores. And one of the reasons why we're able to be nimble in the changes we made in Women's Apparel in contemporary and casual was primarily because of that speed initiative. I'll give it to John and let John talk about the benefits of that and how we see that new process driving success for the remainder of the year. And then I'll hand it to Ed to let him talk about inventory and potential real estate monetization going forward. John?

John James Tighe - *J. C. Penney Company, Inc. - Chief Merchant and EVP*

Sure. Thank you, Marvin. This is John. Last year, we reorganized our whole process for product development and design. And in some areas, we reduced it by over 40% from where we were. This is allowing us to be much faster to market and be more trend right and allowing us to really deliver the right trend and value at a timely basis. We continue to use this as we move through the year and get better at it and will allow us to reorder and be more nimble with the reaction to the customer. We also did lots of consumer research last year and understanding -- better understanding our customer to align our assortment with her needs. And really, what she told us is that she's more casual, and I think everyone realizes the casualization of America continues to expand, and that she loves activewear. So as we go and stand for trend and value by leveraging our design and product development teams, we'll also lean into casual and active to grow our business.

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

Okay. Ed?

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Jeff, on the inventory question. As we said, our inventory is up by 0.8% at the end of the first quarter. The investments -- incremental investments we made in showrooms for appliances and the additional Sephora stores are worth over 300 basis points. So apparel inventory was down at the end of Q1. And as we move forward, we expect the end of the year to be down over 5%. We would still expect that incremental 300 basis points or so for additional showrooms and Sephora. So we are expecting apparel inventories to be down high single digits by the end of the year. And we would expect it to be a continual step-down each quarter between now and then. As far as real estate sales, we continue to look at our assets and if they're worth more to us as real estate as they are to us for stores, we continue to look to try and make deals there. As I mentioned earlier, we expect to have one of those deals later this year. And we think there's probably a handful of stores that, that they may apply to. And we'll continue to look at that and see if that makes sense for us. Although we don't -- I don't expect it to be hundreds of millions of dollars going forward, I do think there continues to be opportunity for us to monetize some assets.



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Operator

Our next question comes from the line of Lorraine Hutchinson with Bank of America.

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

What were the first quarter apparel comps? And where you need them to get to for the remainder of the year to hit that minus 1% to plus 1% comp guidance?

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

Well, for the quarter, overall apparel performed worse than the company comp. I think that's probably the best way to illustrate the overall performance. And candidly, as we look at our sales plan and our guidance of down 1% to plus 1%, apparel is obviously planned down. So we have no great optimism that we're going to swing apparel to positive comps overall. There are categories in apparel, active being one, dresses and some components of contemporary and casual that we are expecting to see positive comps in. But overall, we have apparel planned down appropriately. So if we can hit a plan, which is a modest plan of negative comps for apparel and continue to see the growth trajectory that we discussed in categories, like home and appliances and Sephora and Salon and Fine Jewelry, and all of those other growth areas, including omni, we think we are well within our range for guidance. But we're going to work very hard and we have stretch targets. But those stretch targets won't get us in trouble from an inventory standpoint. And we're in a good position because of the speed initiative that John talked about that we can be nimble and we can make decisions with a lot more data. But overall, we're just going to continue to work on it. But we're not overly optimistic that we're going to swing it to positive.

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

And then it sounds like there will be some gross margin pressure in the second quarter, but what you're seeing quarter to-date, you still feel confident that the second quarter comps can be within your guided range.

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

Yes. And the gross margin pressure, as Ed mentioned, is primarily coming from the liquidation in our closed stores. When you separate the closed store inventory liquidation, we see the go-forward stores as being margin accretive. We expect and plan margin growth.

Operator

Our next question comes from the line of Matthew Boss with JPMorgan.

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

So if we broke down the comp a little further, so versus the negative 3.5%, what was the traffic decline in the quarter? And then just how did private label comp versus national brands?

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Matt, this is Ed. I'll take the second part first. Private brands outcompeted national brands for the quarter. We had a really great quarter in private brands. As we said, margin was up 10 basis points. Margin significantly improved in private brands in Q1 as our sourcing initiatives have really started to kick in. So we feel really good about private brands as we move forward. The first part of your question was about traffic, yes. So AUR was up slightly for the quarter. UPTs was up low single digits. The rest of the loss came from negative traffic.



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

Okay. And then just a follow-up on the gross margin. So 1Q up 10 basis points and then you walked through the 80 basis point headwind in 2Q. Can you just walk through the drivers of the back half gross margin build to bridge to that full year up 20 to 40?

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Yes, and just to be clear, there is 80 basis points of pressure in Q2 from the closing stores. It's -- we're not saying Q2 will be down 80 basis points to last year. We do expect to get some margin accretion, as Marvin just said. We expect fall margins to be up to get us into that range. As I said in my prepared remarks, we continue to see significant benefits from our sourcing initiatives. Even though there's a raw material pricing pressure, we continue to see average unit cost going down in our sourcing group. Also our pricing analytics continues to be significantly accretive to the gross margin. And between those 2, we expect it to continue to build throughout the year and get us into the margin range.

Operator

Our next question comes from the line of Paul Lejuez with Citi.

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

You made some comments during the quarter, I think, about some of your stores that will be -- going to be closed -- or actually going to stay open a little bit longer. And I was just curious what were the sales that we could attribute to those stores in first quarter results. And I'm just curious. You mentioned the margin pressure for 2Q. What sort of comp impact will those liquidation sales have? And I'm just curious how it will impact the comp and gross margin this quarter as well.

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

So Paul, on the second part of your question, we see 0 sales impact for second quarter because we pull those stores from the comp calculation for Q2. But relative to the comp benefit in Q1, it's almost impossible to calculate because we also had cannibalization that occurred from the closing store sales. So as an example, if we have a closing store in a market with 2 additional stores, we saw sales dilution in the existing stores because of the traffic and the closing store. So for us to give a comp benefit or a negative comp impact is virtually impossible to calculate. But what we can calculate is that the closed store performance was margin dilutive to the company just driven by mix. So they hurt margin, but from a sales standpoint, it's virtually impossible to determine what the impact was.

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

Got you. And then just one follow-up. Can you talk about performance at mall locations versus off-mall locations in 1Q? And then also curious if you could talk within mall's performance in A versus B and C centers?

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Paul, this is Ed. I'll take those. We continue to see off-mall outpace mall. It's a couple hundred basis points for the quarter that we see the off-mall outpace the mall. Within malls, there's really no clear winner. You would expect A and B to be outpacing C and D, and we're seeing them all about the same.



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Operator

Our next question comes from the line of Mark Altschwager with Robert W. Baird.

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

I wanted to ask on the marketing front. Can you just talk a little bit more about your strategy there for 2017? And any changes going on? I think advertising efficiency has been one of drivers to SG&A reduction. Just wondering if you think you're investing enough in marketing to drive traffic to the stores and website. There are clearly a lot of exciting changes happening in the stores, but with casual foot traffic suddenly declining in the mall, how are you working to get the word out to potential customers?

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

Yes, Mark, it's a very timely question for us because John mentioned that we spent a lot of time doing a marketing consumer research. And what the research has identified as pretty obviously, we have different customer segmentations. But within those segmentations, they have dramatically different shopping patterns. And they have dramatically different desires and habits on how they consume media information. So we're going to make some shifts in our marketing mix to ensure that we are driving the right marketing media to identify the correct customer for the correct category. We spent a lot of time going through the calendar for the balance of the year making adjustments. And we feel great about the changes that we'll see relative to shifting from print to social and digital, understanding what are the categories and the customer segments we want to identify via mediums like direct mail, but also leveraging the much improved mobile app as a way to drive awareness and retention. So as we think about strategy, we'll see those shifts going to be more customer segment dependent. But relative to do we believe that we have cut too much out of marketing, the short answer is no. As a percent of sales, we outspent all of our competitor on marketing. So we think we are properly funding, Mark, and we just have to get better at the overall allocation of the spend relative to the segments and the categories that we're trying to drive revenue in.

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

That's helpful. And if I could just ask a follow-up on the SG&A side. You made some nice progress there. With the results in Q1 guidance would suggest that the reductions in SG&A slow for the balance of the year. So can you just talk about how much flexibility you have on that front? Why is there still low hanging fruit? And then as the store closures you've identified begin to hit the P&L, I mean, would you expect to see more significant declines in SG&A dollars in the back half of the year? Just any help with those dynamics would be great.

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Sure, Mark. This is Ed again. We continue to believe we have opportunity around SG&A. With the stores closures moving out, that's obviously put some more pressure on there because a significant piece of our dollar savings were coming out of the closed stores. But with them all being closed at the beginning of Q3, most of the dollars savings in Q3 and Q4 will come out of the closed stores. But we know we have opportunities around the entire company. We continue to right-size our corporate office. As Marvin talked about, we advertise at a higher percent in most, if not all, of our peers. We know we have opportunities to be more efficient in the stores from how we sign things to how we receive goods. So we're tackling all of that. We know our supply chain has opportunities as well. So we continue to go after all of our SG&A reductions. And hopefully, we think -- hopefully, there'll be some upside to the guidance we've given, but we're being conservative with that.

Operator

Our next question comes from the line of Dana Telsey with Telsey Advisory Group.



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

As you think about the store closings, what do you see is the cadence of the store closings and the sales recapture rate? How are you planning that?

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

So Dana, on the sales recapture rate, it's something that we're obviously spending a lot of time on. And we think the key for us will be leveraging our e-commerce business, leveraging our loyalty program and making sure that we understand the one-to-one marketing opportunities that exist, even in a market where we don't have a physical store location. I mentioned earlier the importance of omnichannel. And we think omnichannel is going to be significant for us to maintain that recapture rate and that retention rate. Joe McFarland, our EVP of stores, is here and Joe has been leading the closed store efforts. So I'll let Joe kind of talk about the cadence of the store closing process and kind of how we see it for Q2 and where we think will kind of have the process concluded when we get to the end of this quarter.

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

Thank you, Marvin, and good morning. This is Joe. From a store closing standpoint, on Monday, May 22, we will begin the closing store commencement. The closing store process is approximately 9 weeks. And as we begin that commencement, we will -- we'll have an in-store visual sign package calling out store closing. In addition to newspaper ROP, some direct mail, e-mail, we'll have exterior banners on the store to really drive the awareness. As we move through, we have very specific weeks identified that we will begin that closing sale with a 30% to 50% off, and then move forward from there. We have flexibility with great partnership from our third-party liquidator that we have -- we partnered with. We've got some great analytical tools to drive the decisions that we make and the cadence in which we close the stores. All stores will be closed to the public by Monday, July 31.

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

And Dana, this is Ed, just to chime in. All the stores that go into liquidation, well, we don't liquidate all 138, there's a handful that will go into the fall based on lease agreements we have.

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

Well, those will truly be exceptions.

Operator

Our next question will come from the line of Bob Drbul with Guggenheim.

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

I just had a question around the Sephora shops and comp store sales. The stores that have the Sephora shops, like, how are they performing versus the rest of the fleet? And then the second question I have is, can you talk a little more on mattresses and furniture continues to be called off in department stores? What's happening with those categories, is my second question? If you could talk about that. And then third one is fulfillment cost, shipment cost on the e-commerce side. How much of a drag has that been? And how do you have that forecast in the gross margin expectation for this year?



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

Okay, Bob. Look, I'll take the Sephora question and also the fulfillment cost. So on the Sephora, the comps for stores with Sephora shops are up versus stores without. It was one of the key driving factors on identifying stores that would close. We simply did an analysis on capital investment possibilities. And where we have stores performing well were obviously stores with Sephora locations, stores with appliance showrooms, et cetera. And so as I mentioned in my prepared remarks, when we finish this year, we are going to have roughly 650 stores with Sephora shops, which will be roughly 75% of all stores. At that time, we're going to evaluate, which we already are, and look at a combination of new locations and also expanding locations. I mean, we've been exceptionally pleased with the 24 stores this year that we've expanded. And we've expanded, as I mentioned, in some cases, that space by over 50%. And we're seeing expanded sales floor productivity, so it's not diluting productivity. It's actually increasing productivity. Relative to fulfillment cost, we are very pleased with the fact that we run a supply chain and we run an online fulfillment process that is cost effective. I would argue that we're probably one of the few retailers that run a profitable e-commerce business. That's, in large part, due to the excellence of the team, but also the coordination between Mike Amend and also our supply chain leadership team. Mike Amend is in the room and if I could, I want Mike just to talk a little bit about the performance of our e-commerce sites, specifically the mobile wallet that we're rolling out on our new mobile app that launched within the last couple of weeks that we're having success with. Mike, you want to discuss that for a second?

Michael Amend - *J. C. Penney Company, Inc. - EVP of Omnichannel*

Yes. Thanks, Marvin. So yes -- so we recently launched a mobile app with a wallet capability. And so going in stores and talking with customers about opportunities to aid in the shopping experience, both with inside of our store and also outside of our store, we recently added this wallet capability. And what this does is this allows us to be able to put both coupons, expose their rewards that they've earned from our loyalty program as well as that gift cards and other capabilities. And what we believe that this will do is that -- this will allow customers just a simple one-stop shop access for all of these things that they've earned with JCPenney. And so we're very excited about this -- we've seen this with this launch. We're seeing great engagement with our customers. And we believe this is going to continue to drive a great opportunity for us to bring reengage our customers from an ongoing basis and also help in aiding in the in-store experience on doing a variety of things, whether it be picking up their orders, price checking and many more things. So we're very excited about this as we move forward.

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

And look, on mattresses and furniture, we're very excited. We mentioned that these 2 categories positive comp in the first quarter. So I'm going to let John Tighe talk about what our potential growth in these areas are and why we're excited about both categories.

John James Tighe - *J. C. Penney Company, Inc. - Chief Merchant and EVP*

This is John. Last year, we reset our mattress floor to be organized by comfort as opposed to by brand. And we reorganized the vendor structure and the assortment. The response has been terrific as well as our furniture assortment that we readjusted with Ashley's Furniture and private brand. Both businesses are running ahead of plan and beating last year. And we'll be looking to expand into new markets this year to capture share and markets where closed stores are giving us opportunity to get volume.

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

So more to come on that. And we'll be talking a lot more about the expansion of the mattress and furniture categories here in the near future.

Michael Amend - *J. C. Penney Company, Inc. - EVP of Omnichannel*

So one other thing -- Bob, one other thing that I'd add on the online fulfillment. So we are in the process right now of rolling out an intelligent orders sourcing logic capability that is actually live right now for some subs. And as Marvin mentioned earlier, we're moving from around 250 stores doing ship from store to chain-wide, which will expose another \$1 billion of inventory. And so what this new system does is it actually has a realtime



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optimization functionality that looks at speed. It looks at delivery expense. It looks at labor. It also looks at markdowns in terms of current markdowns and future markdown avoidance. So one of the things that we're doing here is rolling out this system to continue to increase driving reduced cost actually of deliveries, and also heavily leveraging our store footprint to drive ship-to-store capabilities, which will also has a reduced delivery expense because delivering to a commercial location versus a residential location is cheaper. And this also helps us get foot traffic to our stores. So a lot more to come here on this capability. But what I'd tell is in partnership with Mike Robbins, our EVP of Supply Chain, he and I are working on a number of really great initiatives that are going to continue to reduce our fulfillment expense within our online business.

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Bob, this is Ed. Just to follow on while we're really optimistic about being to drive those costs down going forward, to answer your question directly, in Q1, fulfillment costs were down high single digits on a per-unit basis, so we continue to see significant improvement even before we hit the systems support we need.

Operator

Our next question comes from the line of Michael Binetti with UBS.

Michael Binetti - *UBS Investment Bank, Research Division - MD and Senior Analyst*

I think as you guys studied your stores for the big changes you made to your fleet this year, you also started testing smaller format appliance pad to smaller support pads, can you give me an idea whether those could be put in as comp drivers into some of your smaller stores? Am I right on that? If so, would you mind commenting on test or those categories that could be a comp driver in some of the smaller boxes in the future?

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

Michael, you are correct. And we are in the process of testing those initiatives as we speak. We've had early success with some of the smaller footprint Sephora locations. We have seen lines out the door of the mall block long in some of our rural locations where we rolled out smaller Sephora locations. And we are now in this 100 store expansion of appliances. We're going to be testing some smaller footprint appliance locations that we're very optimistic will work well for us just because we have the extended product selection online. We can serve a customer regardless of the units we have on the sales floor. I'll let John give a little bit more color on the Sephora test because that's something that we're very excited about.

John James Tighe - *J. C. Penney Company, Inc. - Chief Merchant and EVP*

Yes, this is John. Our Sephora expansion has really worked anywhere we've done it. And we're really thinking about growing Sephora in 2 tracks. There's the expanding out to many of our doors, small stores, urban stores, rural stores, it's been working. While we're thinking about expanding, we're also going back and renovating and expanding our flagships. So this year, while we opened 70 new Sephoras, we also are in a process of expanding to 32 new flagships. And while we've done that, we've seen the dollar per square foot actually increase. So we see the expansion of Sephora continuing into the future.

Michael Binetti - *UBS Investment Bank, Research Division - MD and Senior Analyst*

Okay, And then would you mind just helping us calibrate a little bit of your thinking on the second quarter? I think the gross margin comment. We have one piece of it being 80 basis points of pressure. I think you start -- that's on liquidation, as you start to anniversary some of the appliances, which have a structurally different gross margin. And then maybe some of the other puts and takes there on both the comps and the gross margins. And that's quite a noisy quarter for you in the second quarter. Not quite sure where you're pointing us in the model.



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Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

This is Ed. I'll take that. So without the closing stores, we would expect margin expansion in the quarter within our guidance range of 20 to 40 basis points. And then you layer the 80 basis points of pressure on top of that. I wouldn't make it any more complex than that. There are obviously incremental pressures with dot-com and the appliance ramp-up, but that was incorporated in our plan.

Operator

Our next question comes from the line of Charles Grom with Gordon Haskett.

Charles P. Grom - *Gordon Haskett Research Advisors - MD and Senior Analyst, Retail*

Just to follow up on Lorraine's question earlier that you guys expect comps in the second quarter to be within the range of your full year guide. Did I hear that correctly earlier?

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Yes.

Charles P. Grom - *Gordon Haskett Research Advisors - MD and Senior Analyst, Retail*

Okay, great. And then just on the other components of your full year guide, Ed. Just asset sales, you expect to still be a little over \$100 million. Any color on depreciation and/or the tax rate for the full year?

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Well, on depreciation, we expect it to be down in the \$35 million range, give or take. We also expect interest expense in the \$30 million to \$35 million range before any cost to extinguish debt coming out of the tender. And then on tax rate, we really don't have a tax rate. We're expecting dollars to be, give or take, flat, plus or minus a couple of million.

Charles P. Grom - *Gordon Haskett Research Advisors - MD and Senior Analyst, Retail*

Okay. Great. And then just on the omni, just -- if we could just take a step back. Are your inventory systems between the brick-and-mortar stores and online speaking to one another yet? Because obviously, once you get that congruent, the margin opportunities to your point, Marvin, are significant. And then in addition, can you just give us a little perspective on where you're online SKUs are today relative to your in-store SKU count? And where you think that can grow to over time? And if you have it, as a percentage of overlap of SKUs online versus in-store.

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

So Charles, I'll let Mike Amend take that. He can give you some specific color to your questions.

Michael Amend - *J. C. Penney Company, Inc. - EVP of Omnichannel*

Yes. So -- yes, our inventory systems are connected. Actually, the intelligent sourcing system that I spoke to earlier that we're rolling out right now has a single view, actually near realtime view of inventory, both of our stores as well as dot-com that gets updated. So with that system, as you



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mentioned, one of the great capabilities that we're going to continue to leverage there is the most intelligent sourcing of order fulfillment, right, to leverage the store inventory and the store base as well as our dot-com, DCs. And so over time, we will continue to balance that inventory in an appropriate way to optimize their costs. And one of the great capabilities that this really adds and allows us to do is be able to leverage fashion and some of the other areas that it's harder to understand, what the appropriate sales rate of that's going to be from an online perspective. So we can also spread that across the stores and leverage that, so that was one question. And then speaking to your question in terms of our SKU growth. So our online right now, our SKU capacity -- or online number of SKUs is about twice what our largest store is. In our -- in the first quarter, the SKU count was up about 40%. We believe there's a huge opportunity for us to continue to expand in this space. If you look at what customer feedback is as well as if you look at what customers are searching for on our site, there's a clear opportunity for us to both expand in the categories that we're already in as well as the new categories and with new brands. And so we're in the pilot phase right now, actually, of rolling out a new product information management system, which will allow us to expose a portal directly to our vendors. And with that portal, what the -- what our suppliers will now go to do, our drop ship suppliers that we're currently working on many, many different partnerships with will build and then upload their catalogs directly into our system. And we will start to dramatically increase the assortment that we have available online responding to customer needs in areas. So -- and we're doing this, obviously, with our dropship partners, so they're on that inventory. And they'll ship and fulfill those goods. But we're very excited about that and believe that, that represents a very, very material growth opportunity for us going forward.

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

And Charles, it goes without saying that this is truly not only the future retail. This is modern day retailing. And for us having been very slow and very traditional and, candidly, very old fashioned, about omnichannel, I mean, we made a significant transformation within the last 16 months to a modernized omnichannel retailer that's going to have the ability to leverage every physical store location for fulfillment. I mean, that is significant for retail, in general, and very significant for JCPenney. And that's just the start. So we truly see this as a game changer for us to continue to drive down those fulfillment costs. That last-mile fulfillment cost is going to continue to put pressure on retail of either pure play or brick-and-mortar. And as Ed mentioned, we were managing the costs well, even without these new systems. And as Mike was able to on board these new process and systems, we see that only becoming more efficient.

Charles P. Grom - Gordon Haskett Research Advisors - MD and Senior Analyst, Retail

That's great color. And just one last question for me, Marvin. Obviously, you've been really forward thinking here with the appliances and continuing to roll out Sephora and some of the home installment tests that you are doing, Just -- can you show us a little bit of the playbook into 2018, other parts of the store where you think you guys can get really creative and just more company specific drivers for JCPenney?

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

We have a couple of things that we're looking at. But the foundational focus we have is going to sit around 2 things. Number one, it's going to have to be the value-oriented. We know we serve a value-based customer. For many years, we lost sight of that. And we try to serve customers that were not putting JCPenney in their consideration set. So we know that sweet spot for us is that customer with that household income of \$90,000 a year and less. And we also understand within that, we want to have a very balanced view of selling the whole store. I mean, we've been too focused category by category, and that's why we've gotten ourselves in trouble, being so dependent on apparel that when apparel dramatically downturned and we had no other categories we could lean on. So you're going to see us be much more balanced. We need apparel and apparel will always be important, but we also have to ramp up these other businesses, so that we can have more balance across the entire chain. Having said that, we want to become a dominant home retailer. All the data tells us is that our customers want us to be in these spaces. They want us to sell appliances. It didn't appear counterintuitive initially, but it's one of our best businesses and it's continuing to grow. They want us to be in the beauty business. But also, we want to just serve the customers well. So we'll update the external world on some of these initiatives. But for now, we're very excited about the home strategy regarding appliances and furniture and mattresses and some of these home install initiatives that we are very excited about. And we're very excited about beauty. We're excited about what that does with differentiation standpoint. And we're excited about serving the underserved needs of our plus size and big and tall customer, which we didn't talk a lot about on this call, but we're still working on this. So more to come and we'll -- we're excited about communicating these initiatives here in the near future.



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Operator

And our last question comes from the line of Kristen McDuffy with Goldman Sachs.

Kristen Leigh McDuffy - *Goldman Sachs Group Inc., Research Division - MD and Senior Analyst*

Can you talk a little bit about your plans with respect to future debt reduction? I know you've made a good effort with this \$300 million tender. Would you consider a broader tender as market conditions improve? And also how do you think about using your \$500 million of secured capacity?

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

Sure. I'll take that, obviously. So obviously, we announced the tender earlier this week to take that \$300 million. We have \$1.1 billion of near-term maturities, as we sit today, a little under \$1.1 billion. This will take us down to \$800 million. We continue to assess the market and see if it makes sense to upsize that tender or to initiate an additional tender to reduce those near-term maturities even more than that. But we feel really good about the capital structure. I didn't mention in my prepared remarks, but we've taken \$1.4 billion as debt out at the completion of this tender over the last 3.5 years. And as I did say, we're going to, at a net debt to EBITDA ratio, will end this year at approximately 3x. So we think we've made substantial improvement to our capital structure. And we're going to continue to look for ways to improve it as we move forward.

Kristen Leigh McDuffy - *Goldman Sachs Group Inc., Research Division - MD and Senior Analyst*

And just as a follow-up. Do you think of that \$500 million of secured capacity as a rainy day kind of fund? Or is it something you would be willing to tap to take out some of your unsecured maturities at some point?

Edward J. Record - *J. C. Penney Company, Inc. - CFO and EVP*

As we sit today, it's out there if we need it. If I go and tap it, then I lose that liquidity, basically, especially if I use it to pay down near-term maturities. Right now, we're looking at the unsecured market and seeing if there's anything out there. But it's always there if we need it.

Operator

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

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