

March 18, 2013

CONSUMER RESEARCH

LUXURY, APPAREL & FOOTWEAR

## Sector Update

# JCP Time for Plan B?

Omar Saad  
212-653-8992  
osaad@isigrp.com

Given the mounting controversy surrounding JC Penney and the potential ramifications across the sector of whether CEO Ron Johnson's transformational strategies succeed or fail, we are updating our views from our original "JCP Ripple Effect" note published February 7, 2012. While the company seems to be headed toward serious financial and liquidity issues should sales continue to shrink at a 20-30% run rate, and the market is increasingly pricing in just such a scenario, investors may be overlooking an intriguing alternate outcome. In our opinion, the company still has the call option to isolate its top ~300 locations and transform them into a low-risk, highly profitable REIT-like entity, which could drastically change the way the market values JCP. The company's average occupancy cost of \$4 per square foot (and profit of <\$0 per foot) is far below the average surrounding rents in its top mall locations (we estimate ~\$70 per foot). And our 'cocktail napkin' math indicates that JCP's top 300 stores (out of the 1,100 total) could conservatively generate ~\$1.2 billion of sublet rental income, resulting in a \$10.8 billion enterprise valuation (or ~\$40 per share) assuming a conservative cap rate of 10%.

**Isolating Top 300 locations for Sublet & Removing JCP Nameplate a Potentially Powerful Scenario.** How to unlock the substantial underlying real estate value of top mall anchors is a question that has perplexed investors and industry participants alike for years. In this note, we suggest that JCP may ultimately decide to maximize shareholder value by transforming its top ~300 locations into a premium REIT entity under a new nameplate and converting the layout in order to sublet its space to premium brands and retailers while continuing to operate the remaining 800 locations under JCP's traditional discount-driven department store model. We think JCP's most valuable asset is its low-cost real estate, and we believe there are many premium brands (see slide 4 for a list) that would potentially be interested in subleasing space within the best locations at \$40 per square foot (a nice discount vs. the \$70-80+ they would normally pay for a standalone store) as long as the store was no longer called 'JC Penney', and the brands could control the inventory, personnel, checkout, merchandising, shopping experience, and fixturing. JCP would effectively collect a risk-free, high margin, steady stream of rental income, while simultaneously eliminating fashion and inventory risk. We estimate that JCP's top 300 locations represent ~30 million square feet of prime retail real estate could generate ~\$1.2 billion in annual rental income. Even after backing out 35% operating expenses (reimbursed by the tenant at 110%) and 4% of rental income for property management costs (both REIT industry standards) and another \$4 per square foot for the rent JCP pays to its landlords, we estimate JCP could generate ~\$1.1 billion in net operating income. Capitalizing this income at a conservative cap rate of 10% (vs. premium REITs that command a ~7-8% cap rate), we think this piece of JCP's business could be valued at over \$10.8 billion, or ~\$40 per share, even assuming that this new REIT entity absorbs all of JCP's \$3 billion in debt.

*Continued on next page...*

**What is the rest of JCP worth?** We also suggest that the remaining 800 locations continue to operate under the JC Penney name as a more traditional department store, though updated for many of the brand shops the company has already begun adding, many of which are more befitting of the JC Penney market position. Assuming sales per square foot at these stores can eventually improve to \$100 (up from <\$100 today, but still down from peak SSF of ~\$130 in 2006) and operating margin recovers to 3% (from negative double-digits today), we estimate that this business could generate nearly \$8 billion in sales and \$240 million in operating profit. This implies an EPS contribution of ~70¢, which when applying an appropriate 8x P/E multiple, represents a value of another \$6 per share.

**Brands would likely embrace.** We think the Asian concession-style self operated shop-in-shop format we are suggesting would appeal to many of the brands we cover, especially those that have only limited full-price own-retail exposure. A completely re-imagined JC Penney under a new name could offer the brands a unique opportunity to completely control the merchandising, inventory management, sales & service environment at below market rents in top-traffic malls (and without having to deal with the often challenging buying organizations of department stores). Many of these traditional wholesale brands' current own retail exposure is limited to premium outlet malls, which interestingly are also characterized by the high customer traffic but more reasonable rental costs that we think the transformed JCP would offer.

# What Could JCP Look Like if it Spun Off its Top Locations into a REIT?

## JCP Today Pure Dept Store Model

Stores	1,100
<b>Sales</b>	<b>\$13 bn</b>
<b>'Normalized' EBIT</b>	<b>853</b>
'Normalized' EBIT margin %	6.6% (1)
Interest expense	226
Tax rate	36%
Net income	402
<b>'Normalized' EPS</b>	<b>\$1.83</b>
Enterprise Value	5,447
P/E	8.4
<b>Share price</b>	<b>\$15.48</b>

Take top 300 locations, drop the JCP banner and convert to premium REIT-like concession landlord model

Continue to operate the worst 800 locations under the JCP banner as a discount/value department store chain

## Top 300 Doors: Brand REIT model

Square footage (mm)	30
Rental income per SF	40 (2)
<b>Rental income</b>	<b>1,212</b>
<b>NOI</b>	<b>1,085 (3)</b>
Cap rate	10.0% (4)
EV of Top 300 JCP locations as a REIT	10,847
Less: net debt	(2,150)
Equity value	8,697
Share count	219
<b>Implied value per JCP share</b>	<b>40</b>

## Bottom 800 Locations: JCP Dept Store Model

Square footage (mm)	81
Sales per SF	100
<b>Sales</b>	<b>8,070</b>
<b>EBIT</b>	<b>242</b>
% margin	3.0%
Tax rate	36%
Net income	155
<b>EPS</b>	<b>0.71</b>
P/E	8.0x
<b>Implied value per JCP share</b>	<b>6</b>

**Combined per share value = ~\$45**

### Notes:

(1) Average JCP EBIT margin from 2003-2010.

(2) Assumes ~50% discount to REIT average rental income of ~\$75 per SF in premium malls.

(3) Similar to mall REITs, assumes operating expenses of 35% of sales, reimbursed by tenant at 110%, plus property management costs at 4% of rental income, and \$4 rent per SF that JCP pays.

(4) Assumes 10% cap rate vs. ~8% cap rate for premium mall REITs like SPG.

# Plenty of Brands to Go After

Brands and retailers we think would be willing to sublet concession space in the company's top 300 locations (under a different name plate) at an average of ~\$40 per square foot



# JCP's Most Valuable Asset: Low-Cost Premium Real Estate

	Average Rent cost per SF
Tiffany	\$132
Polo Ralph Lauren	\$113
Apple	\$113
Kay Jewelers	\$109
Coach	\$103
Zales	\$90
Guess	\$90
Nike	\$65
Anthropologie	\$53
Victoria's Secret	\$50
<b>JCP</b>	<b>\$4</b>

# Not Too Late to Change Course

## 2012

- Launched 8 shops across 700 stores = 6mm sq ft (5% of total JCP)
- Spent \$341m in capex on shop-in-shop openings and IT investments
- Shop productivity = \$180 per sq ft (vs. \$134 per sq ft rest of JCP, 33% increase in productivity)

## 2013



- Rolled out to 681 stores

- New Home department rolling out to ~700 stores May 2013 – includes several shops (Michael Graves, Jonathan Adler, Bodum, etc.)
- 6 more apparel shops (Levi's, Dockers, Disney, etc.)
- 40 shops and 40% of stores converted by BTS 2013, ~25mm sq ft (23% of total JCP)
- ~\$1 billion capex

## Long-term Vision

- ~100 shops per store across ~700 stores = ~64,000 specialty shops representing 64mm sq ft (58% of total JCP)

# Does JCP Have Enough Time and Liquidity to Execute Ron Johnson's Vision?

	2012	Run-rate Assuming Flat Comps	Run-rate Assuming -20% Comps
Net income	(985)	(766)	(1,226)
D&A	543	550	550
Restructuring	238	-	-
Stock-based comp	50	-	-
DTA	(467)	-	-
Gain on sales of assets	(397)	-	-
Pension benefit	272	-	-
Other non-cash addbacks	(12)	-	-
Changes in working capital	748	-	-
Cash flow from operating	(10)	(216)	(676)
Capex	(810)	(800)	(800)
Dividend	(86)	-	-
<b>Free cash flow</b>	<b>(906)</b>	<b>(1,016)</b>	<b>(1,476)</b>
Monthly cash burn		(85)	(123)
<b># months liquidity remaining</b>		<b>37</b>	<b>25</b>

Liquidity	
Beg cash balance	850
Line of credit	1,850
Accordion	400
<b>Total liquidity</b>	<b>3,100</b>

Notes:

(1) Months liquidity calculation is total liquidity divided by monthly cash burn.

(2) Second scenario assumes -20% comps over next two years.

# Consumer Research Certifications, Disclosures, and Disclaimers

- **ANALYST CERTIFICATION:** The views expressed in this Report accurately reflect the personal views of those preparing the Report about any and all of the subjects or issuers referenced in this Report. No part of the compensation of any person involved in the preparation of this Report was, is, or will be directly or indirectly related to the specific recommendations or views expressed by research analysts in this Report.
- **DISCLOSURE:** Neither ISI nor its affiliates beneficially own 1% or more of any class of common equity securities of the subject companies referenced in the Report. No person(s) responsible for preparing this Report or a member of his/her household serve as an officer, director or advisory board member of any of the subject companies. No person(s) preparing this report or a member of his/her household have a financial interest in the subject companies of this Report. At various times, the employees and owners of ISI, other than those preparing this Report, may transact in the securities discussed in this Report. Neither ISI nor its affiliates have any investment banking or market making operations. No person(s) preparing this research Report has received non-investment banking compensation from the subject company in the past 12 months. ISI does and seeks to do business with companies covered in this research Report and has received non-investment banking compensation in the past 12 months.
- **DISCLAIMER:** This material is based upon information that we consider to be reliable, but neither ISI nor its affiliates guarantee its completeness or accuracy. Assumptions, opinions and recommendations contained herein are subject to change without notice, and ISI is not obligated to update the information contained herein. Past performance is not necessarily indicative of future performance. This material is not intended as an offer or solicitation for the purchase or sale of any security.
- **ISI RATING SYSTEM:** Based on stock's 12-month risk adjusted total return.

Strong Buy	Return > 20%
Buy	Return 10% to 20%
Neutral	Return 0% to 10%
Cautious	Return -10% to 0%
Sell	Return < -10%

ISI has assigned a rating of STRONG BUY/BUY to 47% of the securities rated as of 12/31/12.\*

ISI has assigned a rating of NEUTRAL to 50% of the securities rated as of 12/31/12.\*

ISI has assigned a rating of CAUTIOUS/SELL to 4% of the securities rated as of 12/31/12.\*

(Due to rounding, the above number may add up to more/less than 100%).

\*Please note as of January 2013 ISI Group LLC has changed our ratings system to the categories described above.

For the distribution of ratings for the quarter ending 12/31/12, what was previously rated as a BUY is now reflected in the Strong Buy/Buy category, what was previously rated as a HOLD is now reflected in the Neutral category, and what was previously rated as a SELL is now reflected in the Cautious/Sell category.