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CONSUMER RESEARCH

LUXURY, APPAREL & FOOTWEAR

Sector Update

JCP Time for Plan B?

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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.

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

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

Top 300 Doors:
Brand REIT model

Square footage (mm)	30	
Rental income per SF	40	(2)
Rental income	1,212	
NOI	1,085	(3)
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	
Implied value per JCP share	**40**	

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

Bottom 800 Locations:
JCP Dept Store Model

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

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
JCP	**$4**

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)	-	-
Free cash flow	**(906)**	**(1,016)**	**(1,476)**
Monthly cash burn		(85)	(123)
# months liquidity remaining		**37**	**25**

Liquidity	
Beg cash balance	850
Line of credit	1,850
Accordion	400
Total liquidity	**3,100**

Notes:

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

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

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