

JCPenney Corporation

4Q08 Preview, Reading The Print, Stay Underweight

Summary: JCP will print 4Q08 EPS Friday (2/20; BMO; call details/summary model herein) – J.P. Morgan modeling EPS of \$0.92 (in-line with the Street and company guidance of \$0.90-\$0.93). Our attention will be on additional clarity surrounding the company's 2009 outlook (see details below), particularly supporting drivers for positive gross profit margins as well as any buckets of potential SG&A savings. All in, we feel comfortable with our estimate for a \$0.30 loss (Street @ +\$0.13), which when adding back a \$0.92 pension expense hit, implies a PF EPS of \$0.62. We see few potential positive catalysts on the horizon and reiterate our Underweight rating and \$10 December 2009 price target. We've outlined a few thoughts ahead of the quarter:

- **We See 4Q EPS @ \$0.92 . . .** We are comfortable with our 4Q EPS estimate of \$0.92, which is in-line with Street consensus, and within the company's recently narrowed guidance range of \$0.90-\$0.93 – see assumptions in Table 1 herein. Recall that JCP revised its prior forecast of \$0.90-\$1.05 in conjunction with its January sales release. As previously reported, 4Q total sales declined 9.9% year-over-year to ~\$5.8 billion, due largely to a same-store-sales decline of 10.8%.
- **. . . But Focus on Margin Breakdown.** Moving down the P&L, we are modeling 463 bps contraction of EBIT margins to 6.8%. During the conference call, we will be focused on management commentary regarding margin details, specifically the level of clearance activity and coinciding impact on GPM dollars as well as the success of any cost savings initiatives, such as workforce management technology, to reduce SG&A dollar spend.
- **Expect Additional Details on 2009 Guidance.** As a reminder, JCP has already provided the following 2009 guidance highlights: (1) SSS decline of 10.0% (consistent with 2H08 average), (2) total revenue decline of “high single digits” (JPM @ -8.4%), (3) modest improvement in GPM rate (JPM @ +41 bps), and (4) SG&A dollars flat YOY (ex. pension expense; see below). We expect the company to provide more details on FY09 expectations/initiatives, including potential re-branding/pricing changes to the American Living line, further workforce reductions, and categories of focus for planned store remodels.

Underweight

JCP, JCP US

Price: \$15.42

Price Target: \$10.00

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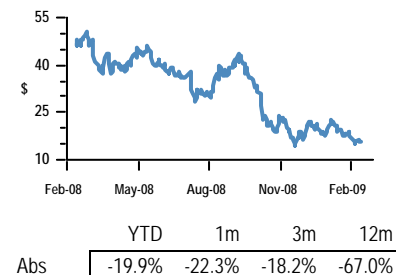
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Price Performance



JCPenney Corporation (JCP;JCP US)

	2007A	2008E	2009E
EPS (Operating) (\$)			
Q1 (Apr)	1.04A	0.54A	(0.30)
Q2 (Jul)	0.78A	0.52A	(0.29)
Q3 (Oct)	1.02A	0.55A	(0.09)
Q4 (Jan)	1.93A	0.92	0.38
FY	4.77A	2.53	(0.30)
P/E (Operating) FY	3.2A	6.1	NM

Source: Company data, Reuters, J.P. Morgan estimates. 3Q07 & FY07 exclude tax benefit of \$0.14

Company Data

Price (\$)	15.42
Date Of Price	17 Feb 09
52-week Range (\$)	51.42 - 13.95
Mkt Cap (\$ mn)	3,449.45
Fiscal Year End	Jan
Shares O/S (mn)	224
Price Target (\$)	10.00
Price Target End Date	31 Dec 09

See page 8 for analyst certification and important disclosures.

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- **Remain Comfortable With Our (\$0.30) GAAP EPS for FY09.** Consensus estimates have moved down to \$0.13 (from \$0.97 just over a week ago), much closer to our forecast for a \$0.30 loss. The biggest delta between our estimate and the Street likely rests with gross profit margins, where we are assuming +41 bps of gains YOY to 37.9%. Along these lines, we think the Street is baking in 70-100 bps of an improvement YOY – an outlook that looks too aggressive. Moving down the P&L, we are modeling SG&A dollar growth of 8.8%, or \$467 million YOY – essentially the \$333 million pension expense (2008) and the \$134 million pension income (2007).
- **Questions For the Call.** During the call we will be looking for JCP to provide an update on: (1) current pulse of the consumer, including traffic and ticket trends across various regions, (2) inventory position and CTR/product flow updates, (3) American Living and new private label brand updates, (4) sales productivity and opening cadence of off-mall stores, (5) pension accounting assumptions for next year, including discount rate and expected rate of return, and (5) further detail regarding the 2009 and 2010 ‘bridge plan.’

A Look Into JCPenney's 4Q08

JCPenney will report 4Q08 EPS before the market opens on Friday (2/20) at around 7.55 AM EST. The company's conference call will begin at 9:30 AM EST (dial-in: 1.807.407.0778). Below is our condensed model for JCPenney's 4Q08 results. Please feel free to contact us for our full working model ahead of earnings.

We are modeling 4Q08 EPS of \$0.92, which is in-line with Street consensus and toward the high-end of the company's revised guidance range of \$0.90-\$0.93.

As a reminder, in conjunction with reporting January sales on February 5th, JCP narrowed its 4Q EPS view from its prior \$0.90-\$1.05 guidance range. From a historical perspective, JCPenney has a consistent track record over the past few years of consistently beating Street consensus – see Table 4 below – though we note that there have been significant downward earnings revisions over the past three quarters prior to the company's actual 4Q release.

Sales: As previously reported, 4Q total sales declined 9.9% year-over-year to ~\$5.8 billion, due largely to a same-store-sales decline of 10.8%. We estimate department store revenue decreased 8.9% to \$5.0 billion while direct sales (Internet & Catalog combined) declined 15.7% to \$757.6 million. During the quarter, JCPenney did not open or close any stores and ended the year with 1,093 total stores. With 26 net new stores opened during FY08, we estimate square footage growth of 2.6%.

Operating Margins: We are modeling EBIT margin contraction of 463 basis points to 6.8%. Breaking down our margin forecast, we are assuming 127 basis points of erosion in gross profit margins to 34.9% due mainly to higher-than-expected markdowns and clearance activity. Positively, JCPenney was able to manage inventory levels to match sales trends, with comparable levels down “low double digits” at year-end. We are modeling, SG&A expenses (as a % of sales), including depreciation and pre-opening costs, to rise 334 bps to 28.3% due to fixed cost deleverage and higher depreciation costs year-over-year (as a % of sales).

Other Items & Share Repurchase Activity: We are modeling interest expense of \$60.0 million in-line with the company's guidance. Also, we expect a tax rate of 38.0%.

Table 1: JPM 4Q08 Forecast vs. Year Ago Results

	4Q07	4Q08E	% YOY growth
Total Revenue	\$6,390.0	\$5,794.1	(9.9%)
Cost of Goods Sold	4,079.0	3,771.9	
Gross Profit	2,311.0	2,022.1	
SG&A Expense	1,475.0	1,505.9	
Depreciation & Amortization	116.0	132.0	
Pre-opening Expense	6.0	5.0	
Total SG&A Expense	1,597.0	1,642.9	
Real Estate and other (income)	(15.0)	(12.0)	
EBIT	729.0	391.3	
Interest Expense	43.0	60.0	
Total Pretax Income	686.0	331.3	(51.8%)
Income Taxes	255.0	125.9	(50.7%)
Net Income	431.0	205.3	(52.5%)
Reported EPS	\$1.93	\$0.92	(52.4%)
Adjustments			
One-Time Item	0.00	0.00	
Operating EPS	\$1.93	\$0.92	(52.5%)
Shares O/S	222.9	223.0	
Margin Analysis:			
Gross Profit Margins	36.2%	34.9%	-127bp
SG&A Ratio	23.1%	26.0%	287bp
Total SG&A Ratio	25.0%	28.4%	334bp
EBIT Margins	11.4%	6.8%	-463bp
Tax Rate	37.2%	38.0%	

Source: J.P. Morgan estimates and Company Reports

Table 2: Guidance Snapshot

	4Q08	FY08
SSS (a)	Down 9%-11%	
Sales (a)	Down 7%-9%	
Margins	Decline	
GPM	Trend better than 3Q	
SG&A Expense	Increase in rate	
Interest Expense	\$60 million	\$55-\$60 million per quarter
Tax Rate	38.0%	38.0%
EPS	\$0.90-\$0.93	
Share Count	223m	224 million
CAPX		-\$1.0 billion
Depreciation		\$475 million
New Stores		36 Gross/25 Net

Source: Company reports and J.P. Morgan estimates; (a) JCP reported 4Q08 sales of \$5.76 billion on a 10.8% comp decline.

Table 3: J.C. Penney's Comp Picture (2006-2009E)

		1-Yr Comps				2-Yr. Stacked SSS			
		2006	2007	2008	2009E	2006	2007	2008	2009E
Monthly	January	2.5%	5.2%	0.0%	(16.4%)	5.0%	7.7%	5.2%	(16.4%)
	February	2.3%	1.5%	(6.7%)		8.2%	3.8%	(5.2%)	
	March	(1.0%)	11.0%	(12.3%)		(1.4%)	10.0%	(1.3%)	
	April	2.6%	(3.4%)	(1.7%)		6.1%	(0.8%)	(5.1%)	
	May	11.1%	(0.9%)	(4.4%)		12.1%	14.0%	(5.3%)	
	June	4.3%	(0.7%)	(2.4%)		11.8%	11.7%	(3.1%)	
	July	4.9%	12.0%	(6.5%)		9.7%	6.5%	5.5%	
	August	(0.5%)	(2.4%)	(4.9%)		2.3%	(2.9%)	(7.3%)	
	September	8.7%	(3.7%)	(12.4%)		10.1%	5.0%	(16.1%)	
	October	8.1%	(1.0%)	(13.0%)		10.5%	7.1%	(14.0%)	
	November	2.5%	5.4%	(11.9%)		6.1%	7.9%	(6.5%)	
	December	3.4%	(7.3%)	(8.1%)		5.6%	(3.9%)	(15.4%)	
Quarterly	1Q	2.6%	3.4%	(7.4%)		5.4%	6.0%	(4.0%)	
	2Q	7.6%	2.9%	(4.3%)		11.8%	10.5%	(1.4%)	
	3Q	6.5%	(2.4%)	(10.1%)		9.0%	4.1%	(12.5%)	
	4Q	3.2%	(2.3%)	(10.8%)		5.8%	0.9%	(13.1%)	
	Annual	4.9%	0.0%	(8.5%)	(9.6%)	9.1%	4.9%	(8.2%)	(18.1%)

Source: Company reports and J.P. Morgan estimates.

Table 4: JCP's Quarterly Actual vs. Expected (1Q05-4Q08E)

Quarter	Date Reported	Actual	JPM	Street	Delta	Result
1Q05	5/17/2005	\$0.63	n/a	\$0.61	\$0.02	Beat
2Q05	8/16/2005	\$0.46	n/a	\$0.38	\$0.08	Beat
3Q05	11/15/2006	\$0.94	n/a	\$0.88	\$0.06	Beat
4Q05	2/16/2006	\$1.71	n/a	\$1.62	\$0.09	Beat
1Q06	5/11/2006	\$0.90	n/a	\$0.83	\$0.07	Beat
2Q06	8/10/2006	\$0.75	n/a	\$0.71	\$0.04	Beat
3Q06	11/9/2006	\$1.26	\$1.22	\$1.23	\$0.03	Beat
4Q06	2/22/2007	\$2.00	\$1.96	\$1.96	\$0.04	Beat
1Q07	5/17/2007	\$1.04	\$1.02	\$1.03	\$0.01	Beat
2Q07	8/15/2007	\$0.78	\$0.77	\$0.77	\$0.01	Beat
3Q07	11/15/2007	\$1.02	\$1.02	\$1.01	\$0.01	Beat
4Q07	2/22/2007	\$1.93	\$1.75	\$1.85	\$0.08	Beat
1Q08	5/15/2008	\$0.54	\$0.50	\$0.50	\$0.04	Beat
2Q08	8/15/2008	\$0.52	\$0.52	\$0.49	\$0.03	Beat
3Q08	11/14/2008	\$0.55	\$0.55	\$0.53	\$0.02	Beat
4Q08	2/20/2009	TBD	\$0.92	\$0.92	TBD	TBD

Source: Company reports and J.P. Morgan estimates.

Rating, Valuation, and Price Target Summary

We rate JCPenney Underweight and our \$10.00 December 2009 price target is predicated on a 50/50 weighted, blended P/E and EV/EBITDA multiple build. Similar to Saks, we no longer expect JCPenney to report positive EPS for FY09 on a GAAP basis. Importantly, we do not view our FY09 EPS estimate of (\$0.30) as “normalized earnings” given the material hit JCP will incur as it marks to market its pension assets/liabilities, which at the end of the day is somewhat uncontrollable by the company. As a result, we believe a proper valuation approach to JCPenney is to “neutralize” this pension swing and account for both EBITDA and EPS on an adjusted basis. To this end, shares of JCPenney are currently trading at 24.9x our 2009E pro-forma EPS of \$0.62, well above its historical low double digit multiple average. In addition it is currently trading at a 7.1x EV/EBITDA multiple. In our price target build, our best case scenario is based on an absolute PE of 12.0x and EV/EBITDA multiple of 6.0x. Conversely, our worst case scenario is based on a PE of 8.0x and an EV/EBITDA multiple of 4.0x.

Upside risks to our rating and price target include: (1) favorable YOY sell through of American Living, (2) further retail consolidation, (3) positive benefits from a reduced promotional environment and (4) the macro picture improving more than expected.

Company Description

JCPenney, headquartered in Plano, TX, began operations in 1902 and is one of America's largest department store, catalog, and Internet retailers. In 2008, JCP reported revenues of \$18.5 billion and over the last five years, the company has averaged year-over-year growth of 1.2% (2004-2008). The company's direct business, including catalog, Internet, and outlets stores, contributed 13.8% of the aforementioned total sales figure.

As of February 2009, the company operated 1,093 stores in 49 states and Puerto Rico. The company's 2007 sales mix was as follows: (1) Women's – 23.0%, (2) Home - 21.0%, (3) Men's - 20.0%, (4) Children's - 11.0%, (5) Accessories – 9.0%, and (6) Footwear - 6.0%, (7) Jewelry – 5.0%, (8) Services & Other – 5.0%.

JCPenney Corporation: Summary of Financials

Income Statement - Annual	FY07A	FY08E	FY09E	Income Statement - Quarterly	1Q08A	2Q08A	3Q08A	4Q08E
Revenues	19,861	18,486	16,933	Revenues	4,127	4,282	4,318	5,759
COGS	12,189	11,556	10,516	COGS	2,477	2,676	2,654	3,749
Gross profit	7,672	6,930	6,418	Gross profit	1,650	1,606	1,664	2,010
SG&A	5,614	5,937	5,829	SG&A	1,411	1,372	1,427	1,631
Operating income	1,631	1,922	1,889	Operating income	248	243	255	390
EBITDA	2,315	1,611	640	EBITDA	358	358	373	522
Interest, net	1,889	1,136	136	Interest, net	53	55	56	60
Other Income	-	-	-	Other Income	-	-	-	-
Pretax income	1,724	912	(109)	Pretax income	195	188	199	330
Income taxes	618	349	(42)	Income taxes	75	72	76	126
Tax rate	35.8%	38.2%	38.5%	Tax rate	38.5%	38.3%	38.2%	38.0%
Net income - reported (GAAP)	1,112	564	(67)	Net income - reported (GAAP)	120	117	124	205
Diluted shares outstanding	225	223	223	Diluted shares outstanding	223	223	223	223
EPS - operating	4.77	2.53	(0.30)	EPS - operating	0.54	0.52	0.55	0.92
EPS - reported (GAAP)	4.94	2.53	(0.30)	EPS - reported (GAAP)	0.54	0.52	0.56	0.92
Balance Sheet and Cash Flow Data	FY07A	FY08E	FY09E	Ratio Analysis	FY07A	FY08E	FY09E	
Cash and cash equivalents	2,471	2,395	2,118	Sales growth	(0.2%)	(6.9%)	(8.4%)	
Accounts receivable	430	400	367	Same store sales growth	-	-	-	
Current assets	6,751	6,285	5,727	EBITDA growth	0.2%	(30.4%)	(60.3%)	
PP&E	4,959	5,466	5,579	EBIT growth	(1.7%)	(39.8%)	(88.0%)	
Goodwill	0	0	0	EPS growth - operating	(2.4%)	(47.0%)	(111.8%)	
Total assets	14,309	14,171	13,522	Gross margin	38.6%	37.5%	37.9%	
Short-term Debt	203	0	506	EBIT margin	8.2%	10.4%	11.2%	
Current liabilities	0	0	0	EBITDA margin	11.7%	8.7%	3.8%	
Long-term Debt	3,505	3,505	2,999	Inventory growth	7.1%	(9.5%)	(7.0%)	
Total liabilities	3,338	2,998	3,303	Debt / EBITDA	1.6	2.2	5.5	
Shareholders' equity	5,312	5,663	5,384	D&A	426	475	504	
Change in working capital	(216)	253	80	Enterprise value / Revenues	0.3	0.3	0.3	
Cash flow from operations	1,244	1,322	552	Enterprise value / EBITDA	2.4	3.4	8.9	
Capex	(1,243)	(982)	(616)	P / E	3.1	6.1	NM	
Free cash flow	53	309	190					
Free cash flow / share	0.24	1.39	0.85					
Dividends	0.80	0.80	0.80					

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Jan

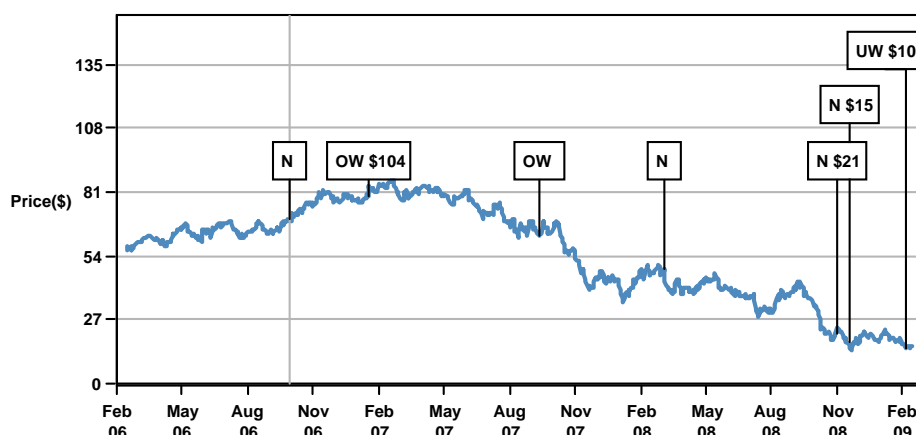
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JCPenney Corporation (JCP) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
29-Sep-06	N	69.28	--
18-Jan-07	OW	79.61	104.00
13-Sep-07	OW	62.71	--
06-Mar-08	N	48.11	--
31-Oct-08	N	21.49	21.00
17-Nov-08	N	17.27	15.00
05-Feb-09	UW	15.42	10.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
 Break in coverage Oct 10, 2005 - Sep 29, 2006. This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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	Overweight (buy)	Neutral (hold)	Underweight (sell)
JPM Global Equity Research Coverage	38%	44%	18%
IB clients*	54%	52%	43%
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IB clients*	76%	71%	62%

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