

BUSINESS OVERVIEW

J. C. Penney is a U.S. apparel and home furnishings retailer operating 1,107 stores, of which roughly half are mall-based.

INVESTMENT HIGHLIGHTS

- **One of the largest department store and Internet retailers in the U.S.** with 112 million square feet of gross selling space. Apparel (~55% of revenue) and home furnishings (~20%) are main product lines. Private-label accounts for ~50% of revenue. Online sales through jcp.com represent ~10% of revenue.
- **Owns 416 stores (~38% of total)**, 15 logistics centers (11+ million sq. ft.), and the HQ in Plano, Texas (240-acre plot). Gross PP&E of \$8.1 billion (\$5.4 billion net) equals ~85% of EV. The balance sheet likely understates fair value, as PP&E is stated at cost and ~60% of total stores opened pre-1990s.
- **Pershing Square and Vornado (VNO) own ~17% and 10% economic stakes**, respectively. While JCP subsequently adopted a “poison pill,” Ackman and Vornado may force the company to sell/spin-off owned real estate and return cash to shareholders.
- **Recent EV-to-EBIT is ~4.5x based on peak 2006/07 EBIT.** If EBIT improves to “only” 75% of peak EBIT (on 10% higher selling space relative to '06), fair value may be \$40+ per share (at 8x EBIT).
- **Same-store sales grew 2% y-y in Feb-Oct 2010.** This suggests revenue growth may be sustained if the economy continues to improve. If not, cost cuts may be an option as headcount is at 2007/08 levels.
- **Chairman and CEO Myron Ullman (63)** joined in 2004. Ullman was previously a Group Managing Director at LVMH and CEO of R. H. Macy & Co.
- **Management targets:** \$5 billion of add'l revenue to ~\$23 billion by 2014 (\$3 billion from existing stores and \$1 billion each from new stores and the Internet), 40% gross and 9-10% adj. EBIT margins.

INVESTMENT RISKS & CONCERNS

- **Valuation already reflects some profit recovery** as shares trade at an implied EV-to-trailing EBIT of >12x. Profitability improvements are dependent on a sustained U.S. consumer spending recovery and cost-containment of rising input prices (e.g. cotton).
- **Potential sales of owned real estate would raise the risk of the retail business**, which would be burdened with additional rent liabilities.
- **Liabilities:** \$1.4 billion of net debt (as of 10/30/10), \$2.9 billion of operating leases and \$4.6 billion of mostly funded gross pension obligations (1/30/10).
- **Inventory is ~85% of tangible book** at October 30.

SELECTED OPERATING DATA

FYE January 31	2006	2007	2008	2009	2010	YTD 10/30/10
Δ same-store sales ¹	4%	5%	0%	-9%	-6%	2%
Δ stores ²	0%	1%	3%	2%	1%	0%
Δ gross selling space ²	0%	2%	3%	3%	2%	0%
Δ sales / gross sq ft	5%	5%	1%	-10%	-7%	0% ³
Δ revenue	4%	6%	0%	-7%	-5%	0%
Δ employees ²	0%	3%	0%	-5%	5%	n/a
Revenue (\$bn)	18.8	19.9	19.9	18.5	17.6	12.1
<i>Selected items % of revenue:</i>						
Gross profit	38%	39%	39%	37%	39%	40%
Adj. EBIT ⁴	9%	10%	9%	5%	5%	4%
Net income	5%	6%	6%	3%	1%	1%
D&A	2%	2%	2%	3%	3%	3%
Capex	3%	4%	6%	5%	3%	3%
Total assets (\$bn)	12.5	12.7	14.3	12.0	12.6	13.0
Tang. equity/assets	32%	34%	37%	35%	38%	38%
Return on tang equity	22%	27%	23%	12%	6%	2%
Stores ²	1,019	1,033	1,067	1,093	1,108	1,107
Gross sq ft (mn) ²	101	103	107	110	112	112
Sales / gross sq ft (\$) ⁵	167	176	177	160	149	108
Sales / net sq ft (\$) ⁵	236	248	248	223	206	n/a
<i>% of revenue by major product category:</i>						
Women's apparel	22%	22%	23%	24%	24%	n/a
Home	22%	21%	21%	20%	19%	n/a
Men's apparel & acc.	20%	20%	20%	19%	19%	n/a
Children's apparel	11%	11%	11%	11%	11%	n/a
Women's accessories	10%	10%	9%	10%	11%	n/a
Δ shares out (avg)	-9%	-9%	-3%	0%	5%	2%

¹ On 52-week basis and including sales from new/relocated stores opened for 12 months and sales through jcp.com. Remodeled stores are also included.

² Period-end. ³ Estimated. ⁴ Excludes impact of the primary pension plan.

⁵ Includes sales for jcp.com.

COMPARABLE PUBLIC COMPANY ANALYSIS

	MV (\$mn)	EV (\$mn)	EV / Rev.	P / Tang. Book	This FY P/E	Next FY P/E
KSS	16,940	16,580	.9x	2.0x	15x	13x
M	10,610	17,480	.7x	21.2x	13x	11x
JWN	9,220	10,990	1.2x	5.1x	16x	14x
SHLD	7,010	10,260	.2x	1.9x	32x	29x
DDS	2,030	2,820	.5x	1.0x	15x	14x
JCP	7,600	9,030	.5x	1.5x	23x	19x

MAJOR HOLDERS

Insiders <1% | Pershing Square 17% | Vornado 10% | JCP staff plans (incl. pension) 10% | Pzena 4% | Legg Mason 3%

RATINGS

VALUE Intrinsic value materially higher than market value?	☆☆☆☆
DOWNSIDE PROTECTION Low risk of permanent loss?	☆☆☆
MANAGEMENT Capable and properly incentivized?	☆☆☆
FINANCIAL STRENGTH Solid balance sheet?	☆☆☆☆*
MOAT Able to sustain high returns on invested capital?	☆☆☆
EARNINGS MOMENTUM Fundamentals improving?	☆☆☆☆
MACRO Poised to benefit from economic and secular trends?	☆☆☆

* Despite financial liabilities, this rating reflects large holdings of real estate.

THE BOTTOM LINE

J. C. Penney's owned real estate has attracted the interest of Pershing Square and Vornado, who disclosed large stakes in the company in October. A potential strategy to reduce JCP's capital intensity and return money to shareholders by monetizing owned real estate may yield rewards, especially if U.S. retail and commercial real estate markets keep recovering. Assuming no change to the current structure, however, shares appear only modestly undervalued based on normalized profitability.