Retail Geeks – Weekly Spin Cycle

January 30, 2012

Welcome to the ***Weekly Spin Cycle***. Each week, we'll deliver some news and commentary about the retail industry. We'll pay close attention to the "managerial spin" and will on occasion offer a contrarian view. You are encouraged to provide any feedback to info@RetailGeeks.com.

Irrationally Exuberant Management at JCP Better Suited for BBY

Last week, **J.C. Penney (JCP - $41.42)** unveiled their new strategic direction and the company's shares skyrockedted +18.0% on the news. Clearly, new CEO Ron Johnson knows the drill. He gave the investment community an *Apple*-like presentation and decided to no longer provide monthly sales metrics or quarterly earnings guidance.

Here's what we liked. Mr. Johnson made it clear that initial mark-up (IMU) does <u>not</u> matter. What matters is the merchandise margin as the product walks out the door (72% of JCP's sales are at a 50% off or greater discount). How many times do investors have to listen to retail management discuss IMU as if it matters?

That said, we found it odd that new CEO Ron Johnson believes that the "#1 opportunity" in retail was the department store. Not the Internet. Nope. Yep, the department store. In addition, his longer-term idea of using 10,000 square feet to develop a "town square" is aspirational, but has 'disaster' written all over it.

The fact is that no matter how smart the presentation sounded, in our view, JCP has about a 5% probability of re-attaining their 13% EBIT margin goal by FY 2015. Yet, today, 95% of the investment community appears all too eager to believe that the 13% EBIT margin goal is within the realm of possibilities.

Many times investors listen to these presentations focused on longer-term strategic initiatives and forget, much like the management teams, that a retailer such as JCP does not operate in a vacuum. For argument sake, let's say that JCP's simplified pricing structure is a success. Don't you think others would emulate the strategy and therefore limit JCP's top-line benefit?

Yes, it was a smart, brilliant presentation by JCP's Mr. Johnson. What analyst does not want to believe that Mr. Johnson can transform the industry especially given his previous successes? But, the new pricing strategy has yet to be tested.

This week, JCP management swung for the fences. The company needed to as it had performed miserably relative to its peers under the direction of ex-CEO Mike Ullman. But, don't forget that The Gap (GPS) began to operate in a much leaner, smarter fashion a few years ago and is still under the direction of a shrewd CEO (Glenn Murphy). And you see where that got GPS. Nowhere.

At the end of the day, we doubt that Mr. Johnson will impact the department store arena as much as he thinks he will. Unfortunately, Mr. Johnson picked the <u>wrong</u> sector of retail. In our view, his skill set was tailor-made for **Best Buy (BBY - $25.44)** and the transformation that's needed in the consumer electronics space.

Therefore, it's a shame that Mr. Johnson's vision could not have been better utilized in a retailing sector that is in greater need of a new strategic direction.

JCP Managerial Comments That Will Be Interesting to Review in 12-24 Months

This week, we were so fascinated by the overly-bullish proclamations made by **J.C. Penney (JCP)** management that we've decided to post the following managerial quotes from the 2-day presentation for future reference:

Ron Johnson - CEO

"The #1 opportunity in American retailing is not the Internet. It's not discount. It is the department store."

"Nothing was bought at full price, fewer than one out of 500 units… 72% of the revenue, three-quarters of everything sold in the stores was at 50% off or greater discount."

"Starting August 1st of this year, we will begin an exercise to add 2-3 shops each and every month for the next 3.5 years until the entire store, every store, is merchandised in shops… in 2013, we will launch Town Square. In 2014, we're going to launch our whole new prototype and by 2015 every one of our stores will be completely transformed."

"This simplistic (pricing) model allows our merchants to do what they do best and that is focus on great product versus focusing on pricing cadence."

"So, if orders are down it doesn't mean the sales expectations are down. What it means is that we want to turn our inventory faster, right… When you make this most money is when you chase the business."

"Shrinkage can be controlled through technology and so we're not going to use labor to protect the merchandise… so, we are not at all concerned about that."

"Localization will not be a primary strategy at *J.C. Penney* because I think that is something that is exaggerated in its importance… if we miss a local item or two, that's okay, because the things we do well will more than offset the opportunity that you can find in localization."

"I don't think that there's any need to go out and close those small stores. And that's looked at by the economics of the stores, not the condition of them."

"Our online percent of sales is still about 9% where *Macy's* with all their growth I believe is at about 6%."

"We do think there's an opportunity over time to slightly reduce the private brand to replace that with more global brands."

"I really believe in credibility and there is absolutely no way that guidance for 2012 that we didn't have extraordinary confidence we could meet or exceed."

Michael Kramer - COO

"We're confident that we can reduce our SG&A as a percent of sales to a sub-30% rate by 2013… we are strongly committed to the fact that we can reduce our SG&A structure to 27% by 2015."

"There's roughly $400M of expenses in the stores that we can cut over the next year, advertising $300M and home office $200M. So, that $900M run rate will not be effective till 2013, but we'll get a portion of that in 2012."

"Here's what we know. Ron said yesterday he's confident that we can get to 40-plus margins. I said today that we're confident that we can get to 27% SG&A structure by 2015. Clearly, doing the math represents a 13% contribution. That's in stark comparison to the 6% contribution that JCP provided in 2010."

"*Sephora* as an example, as we're rolling out Sephora we're seeing a 2% lift in the rest of the store. So, if you take that and exponentially calculate what that can do, as we're bringing in great brands in terms of shops over the course of those 4 years, you can imagine what that can do."

"*J.C. Penney* has roughly 400 stores in those same markets that *Kohl's* has 722… That represents just a comparison of roughly 300 more stores that we can do. And I think that's really important to understand as we roll-out this transformation and when you take a look at the upside potential."