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Retail Industry Comment

J.C. Penney (JCP - $17.32)

J.C. Penney has reached the mid-point of a significant turnaround in operations after a three to four year period of deterioration. The firm's past difficulties were caused partly by the impact of acquiring and putting together five drug store chains to form its large Eckerd Drugstores operation. In addition, catalog sales decline sharply from a peak of about $4 billion in 2000, when the division lost money. In 2001 and 2002, the catalog business improved, yet achieved only minimal profits. The improving profit trend is likely to continue this year, despite a further drop in sales to an estimated $2.4 billion. Total company volume probably will exceed $32 billion.

Despite sluggish economic conditions during the past several months, which adversely affected the company, we are projecting strong margin expansion in the current fiscal year. Moreover, we look for acceleration in sales growth during the seasonally important second half, as Eckerd opens new stores at a more rapid rate. At the same time, industrywide pressure on department stores is likely to ease, in part reflecting easier comparisons with year-earlier volume.

Penny's inventories, which are currently about 7 to 8% over last year's total, are considered dangerously high by many analysts. However, inventories in 2002 were 6% below those of the previous year. Therefore, this year's total is only minimally higher than that of 2001. Moreover, if the firm's volume continues to meet or exceed planned levels, profits in the next several quarters are likely to exceed street estimates. We project full year profits of around $1.80 per share this year, moderately above the company's recent guidance, followed by a strong rise of roughly 50% next year to $2.70 per share.

A summary of the company's balance sheet as of January 25, 2003 follows. Even though S&P recently downgraded Penny's debt securities, the action is difficult for us to rationalize. An examination of the firm's financial condition indicates that cash is strong, inventory turnover is more rapid than the industry average (therefore reducing markdown risk) and long-term debt is less then 36% of total capitalization. Penny's current asset ratio is about 2 to 1 with a large cash position. Moreover, in our opinion the outlook for operations is positive so the balance sheet is likely to improve even further. Finally, book value of approximately $23 per share is well above the current market value of the common stock.

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Balance Sheet as of January 25, 2003 (in millions)

Assets		Liabilities and Stockholder's Equity	
Cash	$2,474	Accounts payable	$3,791
Receivables	705	Short-term debt	13
Inventory	4,945	Current maturities of long-term debt	275
Prepaid Expenses	229	Deferred taxes	80
Total current assets	$8,353	Total current liabilities	$4,159
Property & Equipment (net of depreciation)	4,901	Long-term debt	4,940
		Deferred taxes	1,391
Goodwill	2,304	Other Liabilities	1,007
Other Assets	2,309	Stockholders Equity	6,370
	$17,867		$17,867

Centralized control of operations, combined with further reduction of debt (in line with decreases during the last four years) is expected to result in substantial widening of profit margins during the next six to seven quarters. We have a high regard for current senior management, which was brought in during the 1999 to 2001 time frame. Specific examples of management's capability include the reduction of merchandising inefficiencies in both store divisions as well as the planned elimination of unprofitable portions of the catalog business. Moreover, Penney's management have expanded the firm's profitable internet business into one of the largest such operations on the web.

Analysts Certification: I Alan M. Silverman certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report. I have a long position in the security of J.C. Penney discussed in this report.
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