Credit Research Initiative
Risk Management Institute, National University of Singapore
NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond
transforming big data into smart data
Weekly Credit Brief Oct 24 - Oct 30

JC Penney Co Inc struggles amid retail industry headwinds

by Toh Yong Hui Desmond

JC Penney Co Inc, which operates more than 1000 department stores in the United States and Puerto Rico, has seen its market capitalization tumble by as much as 25% on 27 October. The plunge in share price occurred after the company announced a preliminary update on its expected third quarter performance, warning that the company now expects to report a loss of between USD 0.40 and USD 0.45 per share in the third quarter, worse than analysts' expectations of USD 0.18 loss per share. Correspondingly, the RMI-CRI 1-Year Probability of Default (PD) for JC Penney surged, indicating a weak credit profile (see Figure 1).

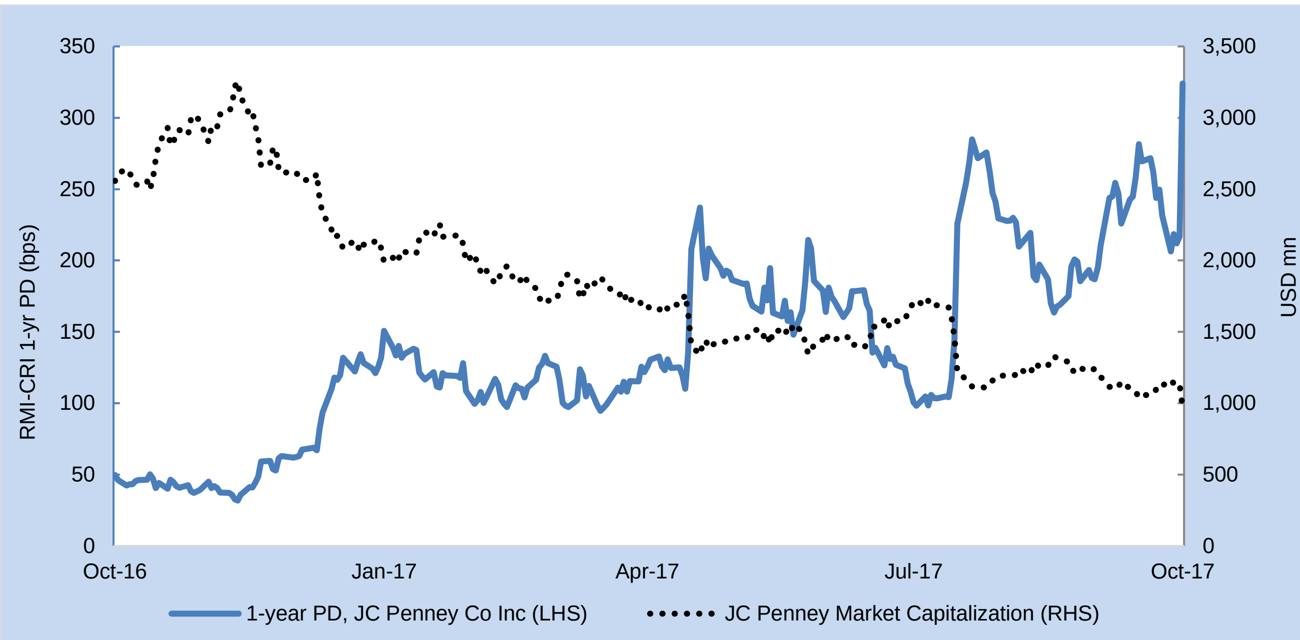

Figure 1: RMI-CRI 1-year PD (LHS) and Market Capitalization (RHS) of JC Penney Co Inc. *Source: RMI-CRI, Bloomberg*

In its preliminary update on expected third quarter performance, JC Penney identified the liquidation of its inventory in closing stores as a driving force of the fall in its profit margins. This was because customers took advantage of the deep discounts at liquidation sales in the closing stores, and stocked up on items available for sale, which caused the company's profit margins to fall. JC Penney's profit margins are likely to deteriorate, as store closures are set to continue, with the company announcing in February this year that it plans to shut down as many as 140 stores in year 2017. Worse still, analysts from a big-data startup have identified another 197 stores with a higher than 64% likelihood of closing, and this would put further pressure on JC Penney's profit margins.

The stiffening competition from online retailers has also exacerbated the erosion of JC Penney's profit margins. Indeed, e-commerce sales have increased in the past few years, with e-commerce sales in the US reaching USD 112bn during Q2 2017, which represents a 16.2% YoY growth and occupies 8.9% of total retail market. The growth in e-commerce has consequently caused store traffic to decline, with JC Penney's comparable store sales extending its decline by 1.30% YoY for Q2 2017 (see Table 1). This problem of poor store sales is worsened by the company's over-reliance on the apparel business, which accounts for more than 50% of its revenue. The apparel business has performed poorly in recent years due to several reasons. Firstly, JC Penney, which only has a market share of 5.78% in the apparel industry, had to face stiff competition from discounters such as TJX Companies Inc and Wal-Mart Stores Inc, which have significantly larger market shares of 11.29% and 15.87% respectively. In addition, JC Penney's focus on apparel sales has made its business susceptible to unexpected weather events, which could render a portion of its apparel inventory incompatible with consumer needs. For example, cold weather apparel has been a particularly tough category in the past few years, due to unseasonably warm temperatures. Moreover, the proportion of U.S. consumer spending on apparel has decreased from 5% in year 2000 to 3.3% in year 2015, according to a report from Cowen & Co. citing the Bureau of Labor Statistics. This would consequently further dampen the outlook for JC Penney's apparel business. As a result, the outlook for JC Penney is bleak, with the company forecasting that comparable store sales in year 2017 would range from a 1% decline to no change.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
Net debt/Equity (%)	343.52	356.56	402.54	274.37	332.78	325.02
Comparable Store Sales (% YoY)	-0.40	2.20	-0.80	-0.70	-3.50	-1.30
Quick Ratio	0.17	0.17	0.06	0.37	0.16	0.14
EBITDA/Cash Interest Paid (X)	1.44	3.69	1.67	7.49	0.38	-

Table 1: Financial Data for JC Penney. *Source: Bloomberg*

To reduce its reliance on the apparel business, JC Penney has sought to pivot its merchandise assortment towards less weather-sensitive categories, such as appliances. However, it is uncertain if this move would be sufficient to offset the apparel weakness entirely, especially when wage growth in the U.S. remains tepid. Average hourly earnings rose by merely 0.1% MoM in August this year, after advancing 0.3% MoM in July this year, keeping the YoY gain in wages at 2.5% for a fifth consecutive month. Such slow wage gains would limit the growth in purchasing power of consumers, thus putting a lid on their discretionary spending on consumer goods, and reducing the effectiveness of JC Penney's strategy of diversifying away from the apparel business.

These challenges have in turn cast doubt on JC Penney's ability to service its debts. As of January 28, 2017, J.C. Penney has over USD 4.67bn in debt, and another USD 2.7bn in operating lease commitments. While its current ratio has stayed above one in recent years, its quick ratio has been significantly lower than one, and this was because a significant proportion of its current assets are in the form of inventories. Such low quick ratio would in turn adversely affect its ability to service its debt obligations, especially in light of recent cases in which suppliers to retailers had turned cautious and sought payments from retailers on a shorter time frame.

Worse still, JC Penney's inventory management is weaker than that of its industry peers along a few dimensions. For example, JC Penney's inventory turnover ratio is the lowest among its main competitors (see Table 2). Since inventory turnover ratio is given by sales divided by average inventory, the low inventory turnover ratio of JC Penney suggests that the company operates poorly in inventory management. Given that inventory constitutes a sizeable fraction of the company's current assets and total assets (see Table 2), such slow inventory turnover could incur significant costs associated with excessive inventory obsolescence, pilferage, maintenance, and insurance. Such effects, coupled with the potential lower net realizable value of its inventories mentioned earlier, would further reduce JC Penney's ability to service its debt obligations.

	Inventory Turnover Ratio	Inventory/Current Assets (%)	Inventory/Total Assets (%)	Net Debt/Equity (%)
JC Penney Co Inc	2.81	83.80	33.35	325.02
Macy's Inc	2.96	75.95	26.80	126.26
Kohl's Corp	3.04	81.29	29.55	79.83
Nordstrom Inc	4.67	59.80	25.45	231.97

Table 2: Financial Data for JC Penney and its Competitors in Q2 2017. *Source: Bloomberg*

In the face of such risks and pessimistic outlook, JC Penney's management has implemented several growth strategies, which include developing the company into an omni-channel retailer to reduce attrition in store traffic, and restructuring its internal pricing process to enhance the company's merchandise margin performance. While such moves are warranted, there are various structural challenges that JC Penney needs to overcome in order to achieve a material improvement in its credit profile.

Credit News

Chinese capital makes rapid ascent in global aircraft leasing

Oct 30. The rise of Chinese banks and lessors in the business of financing aircraft purchases is putting pressures on the returns. As there is a glut of Chinese capital chasing after deals, the Chinese lessors paid high prices for aircraft more than mature financing companies did. The share of Chinese capital in the aviation finance market stands at 28% in 2017 and it is expected to rise to 35% by 2022. The growth of Chinese finance is fueled by a national strategy to build a global aviation industry as demand for air travel increases. IATA, the aviation trade body, is predicting China to displace the US as the world's largest aviation market by 2022. (FT)

China corporate bond investors' luck may be about to run out

Oct 30. Chinese corporate bondholders have so far avoided the brunt of a debt selloff that has driven the 10-year sovereign yields to the highest in three years. However, due to the aggressive deleveraging policies, the accelerating inflation and the risk of increasing borrowing costs in China, the entire bond market may be at risk. The yields on three-year AAA notes have grown 0.21% this month and a slump of China's benchmark 10-year government bond pushed its yield to 3.9%, the highest level since October 2014. According to a bond analyst, the Chinese deleveraging campaign still has a long way to go, and the chance of a selloff in corporate bonds is rising, which will cause a widening yield premium over sovereign notes. (Bloomberg)

Venezuela state oil company says it made vital bond payment

Oct 27. Venezuela's state-run oil company said it made an USD 842mn principal payment on its bond due October 27, spreading a sense of relief to investors in the bond market. The country, which will face many hurdles in coming days, is currently under great pressure of default. Venezuela's decision to disburse the cash for the principal payment indicates that it is likely to meet the second big payment that is due November 2. However, plenty of obstacles remain, including the current challenge of ensuring the cash be distributed correctly and timely to creditors. President Nicolas Maduro has insisted to honor its international obligations even he cuts imports to save cash for debt payment, worsening the current state of recession and hyperinflation. Analysts are certain that the government will default in the matter of time. (Bloomberg)

First Financial quiet on Ching Fu loan default

Oct 27. Ching Fu Shipbuilding Co Ltd, a privately held company has defaulted on its TWD 15.4bn loan with a subsidiary bank under First Financial Holding Co. The Kaohshiung District Prosecuter's Office investigated the shipbuilder for money laundering as it used forged documents to obtain loans from banks. Ching Fu's other creditors include nine state-run banks and loan losses could reach as high as TWD 12.5bn. In 2014, Ching Fu was contracted to build six minesweeper ships for the Navy but the firm failed to import weapon systems for the project after it ran into financial difficulties. (Taipei Times)

Mortgage crisis still claiming victims as Walter plans bankruptcy

Oct 25. Walter Investment Management Corp., the mortgage servicer and lender, faces the deadline of November 1 to get creditors on board with its bankruptcy plan. The company's collapse is caused by the US housing crisis. It needs at least two-third of its term-loan and bond holders to agree for its restructuring to take effect. The pre-packed Chapter 11 plan to be filed by late November would cut the company's USD 2.1bn corporate debt by about USD 700mn and would ideally include some recovery for holders of Walter's convertible notes and existing stock. Although the holding company will file for bankruptcy, the operating entities will continue their ordinary operations. The company said it has 'ample liquidity to support its business' and the reorganization is expected to be completed by January 31. (Bloomberg)

Daewoo Shipbuilding drops almost 65% as trading halt ends (FT)

Marco Polo asks noteholders' to vote on big haircut, waivers for 5.75% bonds due 2016 (Straits Times)

Oi creditors extend confidential talks over restructuring plans (Reuters)

Regulatory Updates

RBI's loan classification numbers don't match banks'

Oct 30. The Reserve Bank of India may question the classification techniques used by auditors to report non-performing assets (NPA) after checks revealed a difference of USD 978mn between the bank's NPA amounts and those reported to the central bank. Bankers interviewed by the Economic Times say that most of the non-performing assets during the last Fiscal Year are infrastructure loans that have been repaid. Auditors, on the other hand say that the differences are due to a change in accounting standards from GAAP to Indian Accounting Standards, as well as the time difference between the RBI's inspection and auditors' reporting periods. (Economic Times)

China to tighten regulation of fintech consumer loans

Oct 29. The regulation on online consumer lending is going to be tightened by Chinese government as part of a campaign against financial risks. Although authorities have encouraged growth of consumer credit as a way to rebalance the economy towards consumer spending, concerns are rising on irresponsible lending practices online. Due to the regulatory crackdown on peer-to-peer (P2P), online consumer lending has replaced P2P as the new area in Chinese fintech market. Compare to an increase of RMB 830bn short-term consumer loans in 2016, the figure grew by RMB 1.49tn through the first nine months of this year. According to Caixin news website, the China Banking Regulatory Commission is drafting a regulatory framework on internet consumer lending and a district government in Shanghai has called a meeting with consumer loan companies warning them against the use of violence to force repayment and charging interest rates above the legal limit. (FT)

Insurance watchdog urged to rethink solvency rules (FT)

Sri Lankan banks minimum capital requirements increased (The Sunday Times Sri Lanka)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Liu Hanlei