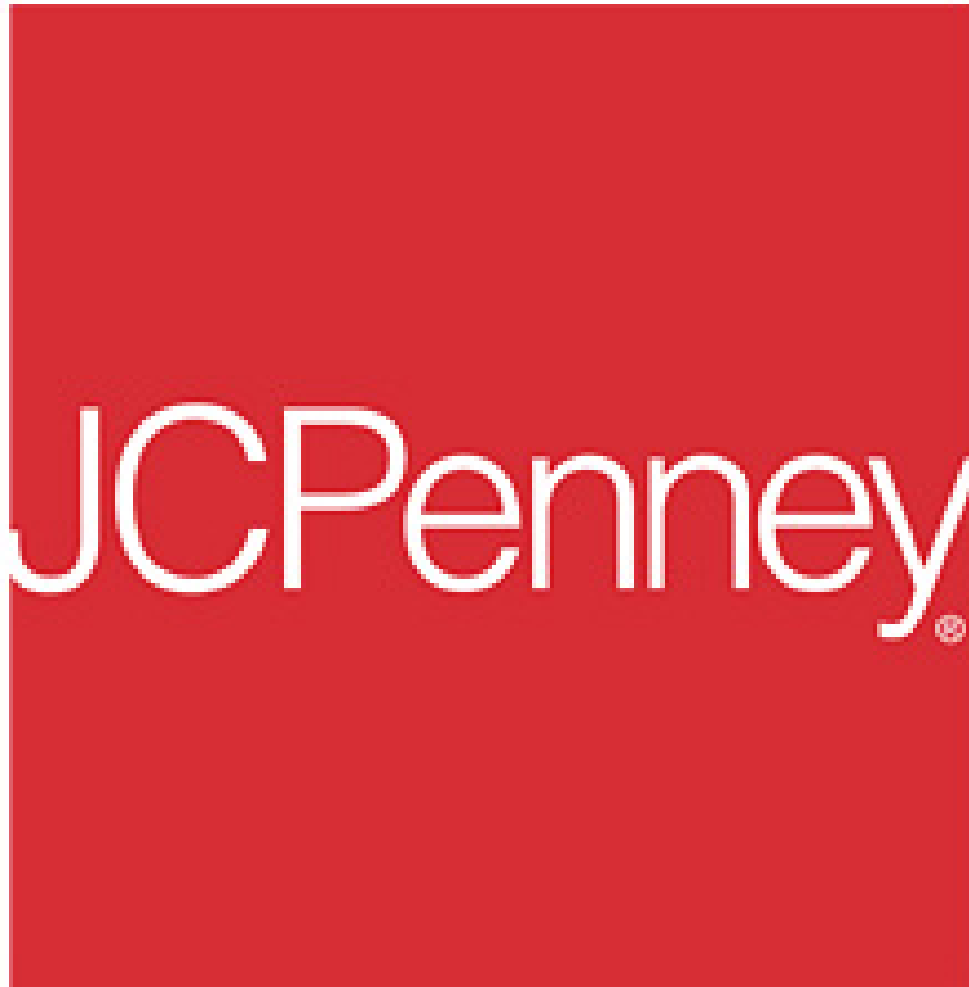


J. C. Penney Company, Inc. Equity Valuation and Analysis

As of June 1, 2007



Innovative Analysis Group

Devon Bartholomew
Rachael James
Daniel Moody
Ana Tapia
Sherrelle Walker

devon.bartholomew@gmail.com
rach_jam@yahoo.com
dan946@gmail.com
ana.tapia@ttu.edu
sherrelle_walker@hotmail.com

Table of Contents

Executive Summary	3
Business & Industry Analysis	8
Company Overview	8
Industry Overview	10
Five Forces Model	12
Rivalry Among Existing Firms	12
Threat of New Entrants	18
Threat of Substitute Products	20
Bargaining Power of Buyers	22
Bargaining Power of Suppliers	25
Value Chain Analysis	28
Firm Competitive Advantage Analysis	34
Accounting Analysis	40
Key Accounting Policies	41
Potential Accounting Flexibility	47
Actual Accounting Strategy	49
Quality of Disclosure	50
Qualitative Analysis of Disclosure	51
Quantitative Analysis of Disclosure	53
Sales Manipulation Diagnostics	54
Expense Manipulation Diagnostic	62
Potential "Red Flags"	68
Coming Undone (Undo Accounting Distortions)	69
Financial Analysis, Forecast Financials, and Cost of Capital Estimation	71
Financial Analysis	71
Liquidity Analysis	71
Profitability Analysis	79

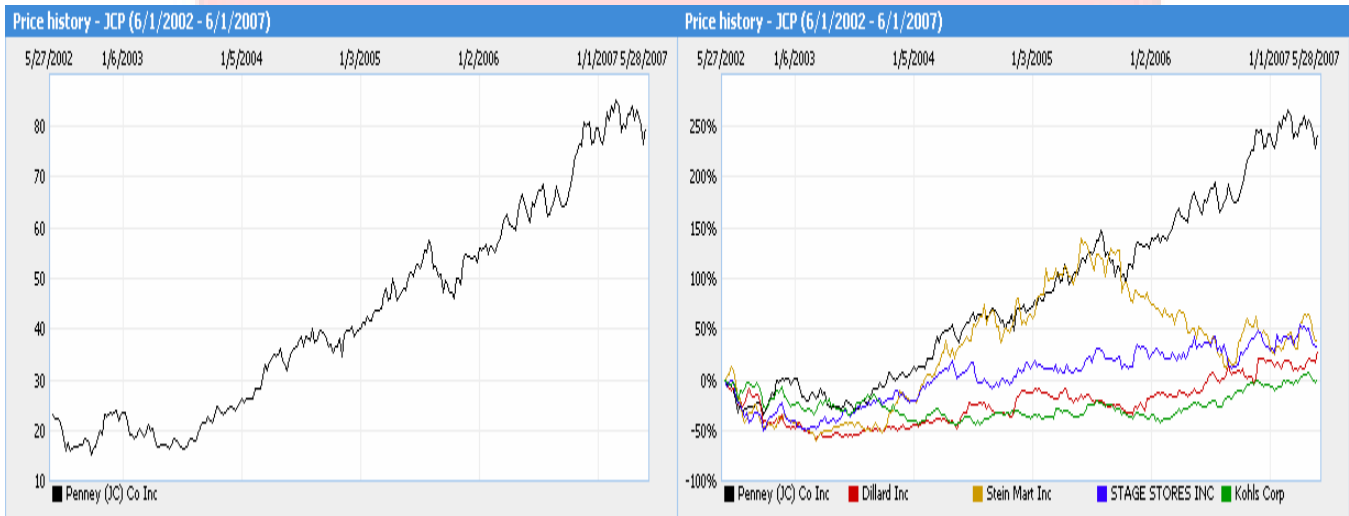
Capital Structure Analysis	84
IGR/SGR Analysis	88
Financial Statement Forecasting	90
Analysis of Valuations	101
Method of Comparables	101
Cost of Equity	110
Cost of Debt	111
Weighted Average Cost of Capital	112
Intrinsic Valuations	113
Discount Dividends Model	113
Free Cash Flows Model	115
Residual Income Model	117
Long Run Return on Equity Residual Income Model	120
Abnormal Earnings Growth Model	122
Credit Analysis	126
Analyst Recommendation	127
Appendix	129
Liquidity Ratios	129
Profitability Ratios	130
Capital Structure Ratios	131
Method of Comparables	132
Regression Analysis	133
Cost of Equity	143
Cost of Debt and WACC	144
Discount Dividends Model	145
Free Cash Flows Model	146
Residual Income Model	147
Abnormal Earnings Growth Model	148
Altman Z-score	149
References	150

Executive Summary

Investment Recommendation: Overvalued, Sell (6/1/2007)

JCP - NYSE(6/1/2007):	\$81.99	Altman's Z-score	
52 Week Range:	\$61.20 - \$87.18	2002	2003
Revenue:	\$19,903 M	2.75	1.91
Market Capitalization:	\$18.51 B	2004	2005
Shares Outstanding:	\$226 M	3.03	3.43
3-month avg. Daily Trading Volume:	3,824,300	2006	3.80
Percent Institutional Ownership:	89.70%	Valuation Estimates	
Book Value Per Share:	\$18.99	Actual Price (6/1/2007): \$81.99	
ROE:	28%	Financial Based Valuations	
ROA:	9.30%	Trailing P/E: \$82.76	
Cost of Capital est.	R2	Beta	K_e
Estimated:			
3-month	0.1913	1.1306	8.41%
6-month	0.1911	1.1302	8.40%
2-year	0.1895	1.1252	8.40%
5-year	0.1886	1.1215	8.40%
10-year	0.1183	1.1203	8.39%
Published Beta:	0.58	Forward P/E: \$75.61	
Kd(AT):	4.04%	P.E.G.: \$42.55	
WACC(BT):	8.72%	P/B: \$60.20	
		P/EBITDA: \$21.40	
		P/FCF: N/A*	
		EV/EBITDA: \$72.17	
		Intrinsic Valuations	
		Discount Dividend: \$16.06	
		Free Cash Flows: \$36.70	
		Residual Income: \$26.61	
		LR ROE: \$15.33	
		AEG: \$22.88	

* Irrelevant due to negative cash flows



<http://moneycentral.msn.com>

<http://moneycentral.msn.com>

Industry Analysis

In 1902, James Cash Penney opened the first J. C. Penney in the town of Kemmerer, Wyoming under the name the Golden Rule. It has become one of the largest department and discount retail chains in America. Its target market consists of middle-income families who want the convenience of shopping for a variety of goods at affordable prices without sacrificing quality. J. C. Penney operates 1,033 department stores in 49 states and Puerto Rico as of February 3, 2007. It has also expanded to serve its consumer base by offering its products and services via the internet and through distribution of its general merchandise catalog.

Direct competitors of J. C. Penney include Kohl's, Dillard's, Stage Stores, Inc., and Stein Mart. Existing firms compete for market share based on economies of scale, tight cost controls, and investments in brand image. This competition nearly eliminates any possibility of new entrants entering into the industry. The majority of products found within this industry are similar, the threat of substitute products is high and the switching costs for buyers are extremely low. Many of the companies within this industry compete on price while trying to maintain a certain level of quality in their products.

Firms within this industry try to differentiate their product lines. J. C. Penney is a prime example of how this marketing strategy can help increase a company's market share within the retail industry. However, differentiation does not come without a price. Because of the contracts and patents that come with this process, the bargaining power of a firm's suppliers jumps from a low to a moderate level.

The key success factors within this particular industry play an important role in gaining a competitive advantage. The key success factors within the department store retail industry are economies of scale, lower input costs, and investment in brand image. Staying on top of these key success factors allows a company to stay one step ahead of the competition, thus maintaining and even gaining more market share.

Accounting Analysis

Profitability relies on key accounting policies correlating with key success factors. Managers within different industries have realized that by using “creative” accounting, financial statements can be manipulated to keep shareholders satisfied. Due to the flexibility allowed by GAAP, this has become a very simple task and has made accounting analysis a very important step in valuing a firm.

One of J. C. Penney’s key success factors is economies of scale and that makes the accounting disclosure of continuous growth very important. J. C. Penney fully discloses its plans within its 10-K and provides percentages, further illustrating how the company has achieved transparency.

Another key accounting policy is J. C. Penney’s judgment over which discount rates to use when valuing liabilities. Pension plan costs can be hidden by using aggressive discount rates reducing the present value of these liabilities. J. C. Penney increases its transparency by disclosing its discount rates for all pension related liabilities. Another area of flexibility within the financial statements involves the discount rates used in operating and capital leases. J. C. Penney, like most of the department store retail industry, uses operating leases; however, J. C. Penney fully discloses its future payments, present value of future liabilities, and most importantly, the discount rate used to value those payments and liabilities.

J. C. Penney does a great job of disclosing areas of accounting flexibilities, as mentioned above, throughout its 10-K. J. C. Penney’s transparency has improved within the last several of years during its turn around and shows the value of the company to shareholders by providing valuable information that its competitors fail to provide.

During the accounting ratio analysis, no potential “red flags” were uncovered, and operating leases were not substantial enough to require restatement. This further demonstrated J. C. Penney’s high-level of disclosure and overall transparency.

Financial Analysis, Forecast Financials, and Cost of Capital Estimation

Analysts have developed a series of financial ratios to breakdown a firm's financial statements into numbers that are compared to those of its competitors within its industry. They evaluate the firm's liquidity, profitability, and capital structure. These ratios are also used to help forecast financials allowing us to see changes in the value of the firm over time. Finally, a regression model is constructed to find an accurate Beta and calculate cost of debt, cost of equity, and weighted average cost of capital.

The liquidity ratio analysis shows that J. C. Penney is a liquid firm. The current ratio, inventory turnover, receivables turnover, and working capital turnover reveal that J. C. Penney's performance is in keeping with the industry as a whole. The only exception is in the analysis of the quick ratio, where J. C. Penney outperforms its competitors, meaning it is potentially healthier than its main competitors. The profitability ratios show that J. C. Penney is outperforming its competitors in areas such as return on assets and equity. In areas of weakness such as asset turnover and operating profit margin, J. C. Penney's performance is converging with the industry. Finally, the capital structure ratios show that J. C. Penney is still transitioning from selling subsidiaries Eckerd Pharmacy and Rojas Renner S. A. and is converging with industry average. On the other hand, debt to equity is a bit higher than the industry average because of J. C. Penney's recent investment in brand image and growth.

We forecasted J. C. Penney's financial statements for the next ten years using the previous financial ratios. After analyzing year-over-year changes in income, as well as the overall industry averages, we predicted an annual growth rate of 6 percent in J. C. Penney's income. When coupled with the asset turnover ratio and the forecasted sales, these numbers helped forecast total assets. Forecasted sales were used to find operating cash flows because a trend was discovered when using the CFFO/NI ratio.

Valuations

After an analyst finishes analyzing the industry, accounting policies, and financials, the valuation of a company becomes a simple task. One becomes an expert within the field and can use several valuation methods to derive the share price of a company. Once these valuations are calculated and weighted by accuracy, one can determine if the firm is overvalued, fairly valued, or undervalued.

Method of comparables ratios are first ran as quick screening methods to valuate share price to the industry average. These different valuation ratios for J. C. Penney consistently derived that our market share price was overvalued. There was a wide range of prices from the dividend yield ratio of \$14.40 to the trailing price ratio of \$82.76. This wide gap further proved that these methods are very inaccurate and should not be used alone to value the firm.

Our final estimates are based on intrinsic valuations. The discount dividend model is given little weight because of its inaccuracy. J. C. Penney's low paying dividends drive its share price to \$16.06. Another inaccurate model is free cash flows, which weighs the total present value of free cash flows and the perpetuity equally. This model priced shares at \$36.70. Next is the residual income model. This model is more reliable because most of the value comes from forecasted earnings. This model valued shares at \$27.33. The long-run return on equity residual income model is based off the same theory except it only uses a perpetuity. It is very accurate, though, because it links the cost of equity, long-run return on equity, and long-run growth on equity. This model valued shares at \$15.33. The abnormal earnings growth model is related to the residual income model because of their link in valuations. We were able to achieve a relative price to the residual income of \$17.40. Overall, the valuation models further prove that J. C. Penney is extremely overvalued.

Business & Industry Analysis

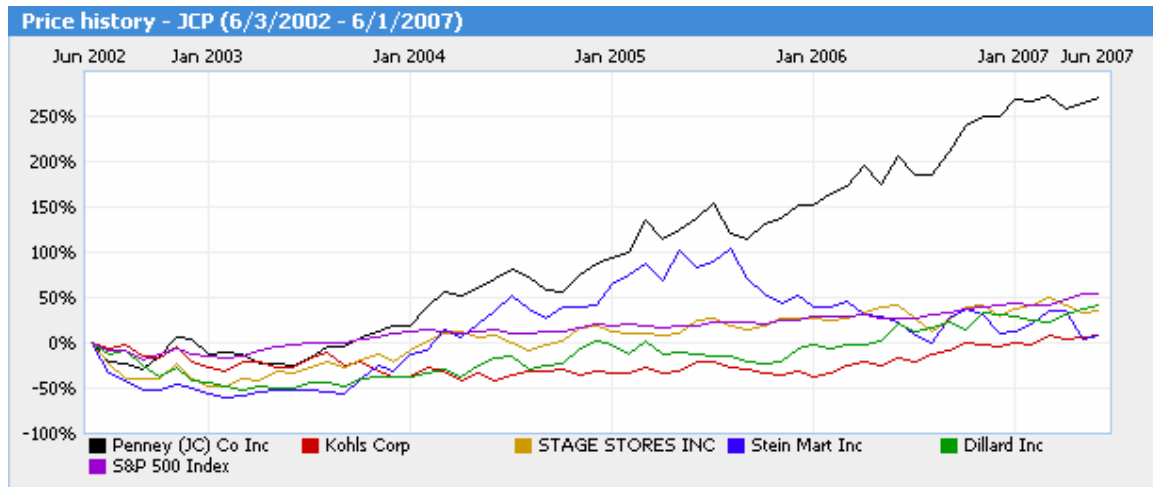
Company Overview

J. C. Penney Company, Inc. (JCP) is one of America's leading department store retailers. In 1902, James Cash Penney opened the first J. C. Penney department store, originally named The Golden Rule, in the small mining town of Kemmerer, Wyoming. Since then, J. C. Penney has become one of the largest retailers in the department and discount segment of the retail industry with 1033 stores in 49 states and Puerto Rico. In addition, J. C. Penney operates "one of the largest apparel and home furnishing sites on the Internet, jcp.com, and the nation's largest general merchandise catalog business" (www.jcpenney.net). Today, the J. C. Penney headquarters is located in Plano, Texas.

J. C. Penney sells merchandise and services to consumers through its department stores, catalogs, and internet channels. "Through these integrated channels, J. C. Penney offers a wide array of national, private and exclusive brands which reflect the Company's commitment to providing customers with style and quality at a smart price" (www.jcpenney.net). Some of the merchandise sold by J. C. Penney includes family apparel, jewelry, shoes, accessories, and home furnishings. Some of the services provided by J. C. Penney include salon, optical, portrait photography, and custom decorating.

There are over 10,000 companies in the department and discount segment of the retail industry; however, J. C. Penney's major competitors include Kohl's (KSS), Dillard's (DDS), Stage Stores, Inc. (SSI), and Stein Mart (SMRT). J. C. Penney has a market cap of \$18.51 billion. With a market cap of \$24.44 billion, Kohl's is the only competitor in this group that surpasses J. C. Penney in this area. Nevertheless, over the last five years, J. C. Penney's net sales have surpassed that of all its main competitors, including Kohl's. Furthermore, J. C. Penney's stock performance has vastly exceeded the S&P 500 and all the stocks

of J. C. Penney's direct competitors. Year-over-year, J. C. Penney's stock price has climbed 20.18 points or 32.65 percent. Over the past five years, J. C. Penney's stock price has climbed 59.97 points or 272.34 percent.



<http://moneycentral.msn.com>

J. C. Penney is also focused on continued growth within the department and discount segment of the retail industry. J. C. Penney recently announced plans to open 250 new stores over the next five years and renovate about 300 existing stores by 2011. The opening of new stores coupled with J. C. Penney's year-over-year positive same store sales growth is indicative of the Company's commitment to continued growth and expansion of its market share within the retail industry.

Total Assets, Net Sales, and Comparable Sales Growth

	2002	2003	2004	2005	2006
Total Assets*	\$17,787	\$18,300	\$14,127	\$12,461	\$12,673
Net Sales*	\$17,384	\$17,513	\$18,096	\$18,781	\$19,903
Sales Growth	2.80%	0.80%	4.90%	2.90%	3.70%

*in millions

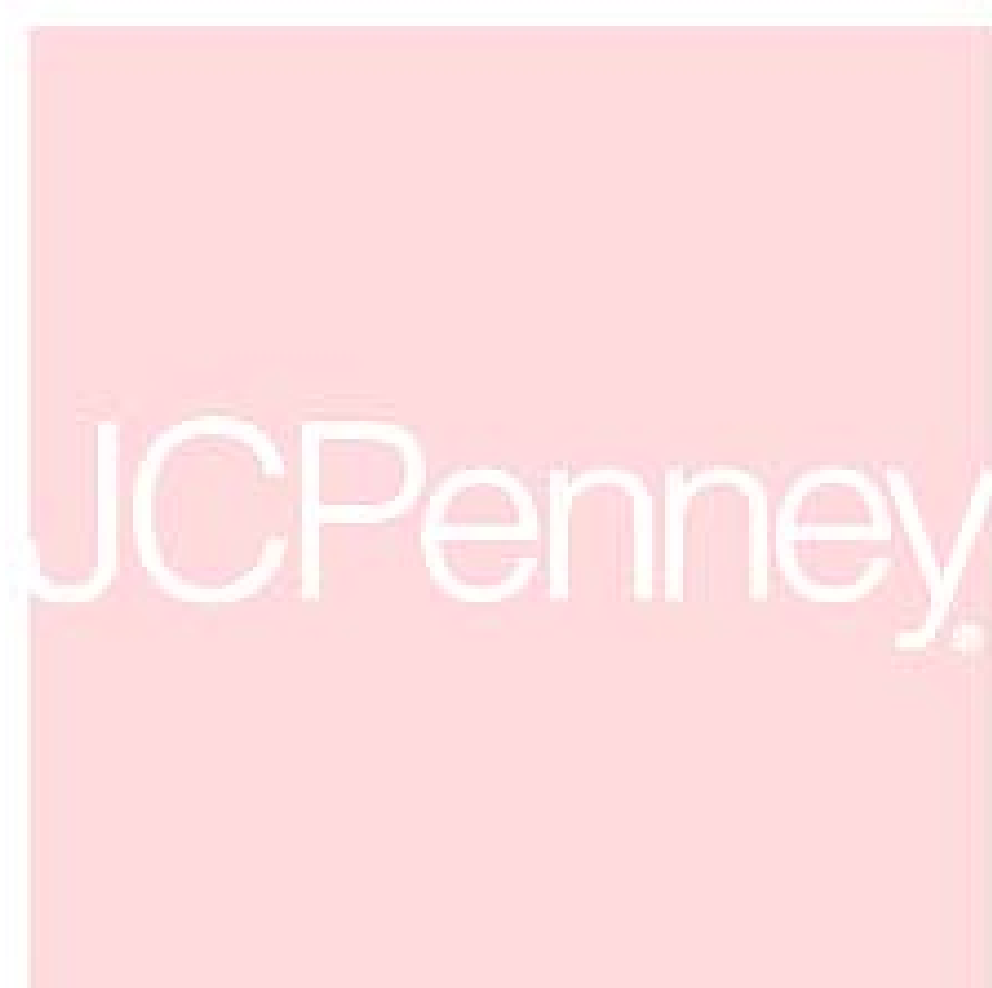
Industry Overview

The retail industry is broken into eight segments, which include apparel, catalog and mail order, department and discount, drugs, grocery, home improvement, specialty, and technology. Because of its wide array of retail merchandise and services, J. C. Penney is placed in the department and discount segment of the retail industry. The companies in the department and discount segment had combined annual revenue of approximately \$475 billion, in 2006 (www.firstresearch.com). The major competitors of J. C. Penney within this segment include Kohl's, Dillard's, Stage Stores, Inc. and Stein Mart.

The department and discount segment of the retail industry "includes 10,000 companies that operate 40,000 stores. The industry is highly concentrated: the 20 largest companies operate 26,000 stores and hold 95 percent of the market" (www.firstresearch.com). However, since the companies within this segment provide similar products and services, they are forced to compete primarily through merchandising and supply chain management. The profitability of individual companies within this segment relies greatly on correct merchandising and efficient supply chain management. For instance, J. C. Penney has launched a new "Every Day Matters" advertising campaign and has begun offering a large selection of private and exclusive brands in addition to an already extensive line of national brands in an effort to separate itself from its competition. The Company's goal is to attract middle-income consumers by providing stylish, high quality merchandise at a reasonable price.

The department and discount segment of the retail industry can be further divided into three unique tiers. The first tier, luxury department store retailers, caters to wealthy, style conscious consumers who are more concerned with brand name products and superior customer service. This tier includes retailers like Neiman Marcus, Nordstrom's, and Saks 5th Avenue. The second tier, department store retailers, targets middle-income families who are concerned with style, quality, and affordability. This tier includes retailers like J. C. Penney,

Kohl's, and Dillard's. The final tier, discount retailers, seeks to provide products and services at the lowest possible price. They target the price sensitive consumer, who desires low prices over style and quality. This tier includes retailers like Wal-Mart, Target, and Ross.



Five Forces Model

The Five Forces Model is an industry analysis tool that enables analysts to evaluate and classify a particular industry's structure and sources of profitability. The Five Forces Model first examines three sources of competition within an industry. These sources of competition include rivalry among existing firms, the threat of new entrants, and the threat of substitute products. The Five Forces Model then examines the comparative economic power of buyers and suppliers relative to the firms within an industry. In other words, the Model assesses the bargaining power of buyers and the bargaining power of suppliers. In essence, the Five Forces Model provides analysts with a method for gauging the potential problems affecting the overall profitability of the firms within an industry.

RETAIL INDUSTRY (DEPARTMENT AND DISCOUNT)

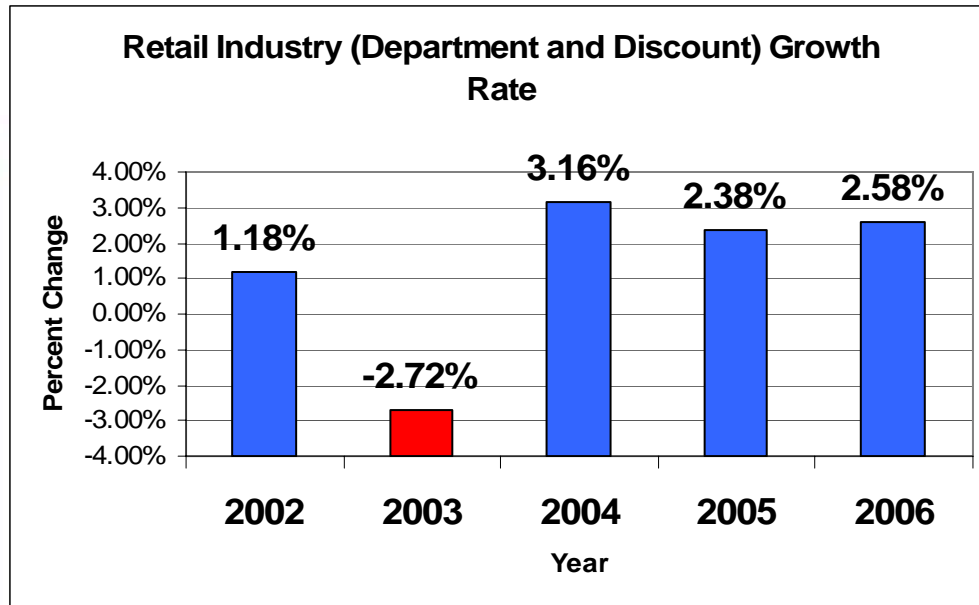
Rivalry Among Existing Firms	High
Threat of New Entrants	Low
Threat of Substitute Products	High
Bargaining Power of Buyers	High
Bargaining Power of Suppliers	Moderate

Rivalry Among Existing Firms

The department and discount segment of the retail industry is highly competitive. Companies already in the industry face significant challenges, which include slow industry growth, little differentiation of products and services, low switching costs and few exit barriers. In order to be profitable, a firm must maximize efficiency throughout its supply chain and focus aggressively on merchandising to attract customers. Other factors that affect the success of existing firms in this sector but have less overall influence on profitability include

high concentration, vast economies of scale, low fixed to variable costs, and a controllable amount of excess capacity.

Industry Growth

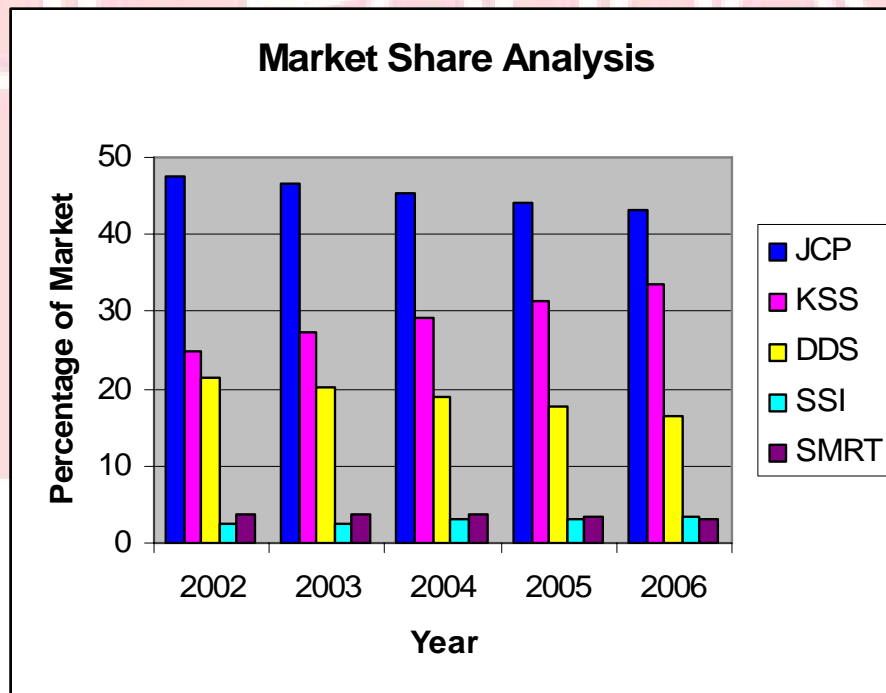


*Percentages derived from the average comparable sales growth of JCPenney, Kohl's, Dillard's, Stage Stores, Inc., and Stein Mart, Inc.

Industry growth plays an integral role in competition. Rapidly growing industries reduce the necessity of firms to take market share from one another. Conversely, in industries with stagnant growth firms must constantly wrestle market share from one another to increase market share. Growth in the department and discount segment of the retail industry is slow. There is little incentive for new firms to enter the market, and those firms that already exist survive and grow either by acquiring smaller companies with an installed customer base or by taking customers away from other existing firms through aggressive merchandising. The most successful firms spend billions of dollars every year on advertising and promotions to attract new customers and retain old customers. From the above chart, it is easy to see how slow growth is within the second tier of the department and discount segment of the retail industry from year to year.

Concentration

The level of concentration within an industry directly affects the level of competition. For instance, an industry with only a few controlling firms is considered to be highly concentrated and allows for collusion and price fixing. An industry with a large number of firms is considered to have low concentration and must compete by price reduction and efficient supply chain management. Concentration within the department and discount segment is high. Although there are over 10,000 companies and over 40,000 stores nation wide, the 20 largest companies own roughly 26,000 stores and control 95 percent of the market. Even with such high concentration, competition amongst the largest firms is extremely intense. In the following chart, it is obvious to see that as one retailer increases its market share another's decreases because growth is extremely limited within the department and discount segment of the retail industry.



*Percentages derived from the net sales reported by JCPenney, Kohl's, Dillard's, Stage Stores, Inc., and Stein Mart, Inc.

Differentiation and Switching Costs

The products and services offered by firms in the department and discount segment of the retail industry are often similar in quality and price; therefore, customers have a very low switching cost. Switching cost is the expense, whether time or money, that a consumer must expend in order to change from one firm to the next. Most consumers are indifferent between shopping at one department store as opposed to another. In order for a firm to be profitable it must find ways to differentiate its products and services from its competitors. This is accomplished by creating private labels, signing exclusivity contracts with various brand name manufacturers, and creating a more enjoyable shopping experience. Another way this is accomplished is through regular sales and discounts.

Economies of Scale

Total Assets

	2002	2003	2004	2005	2006
JCPenney	\$17,867	\$18,300	\$14,127	\$12,461	\$12,673
Kohl's	\$6,315	\$6,698	\$7,979	\$9,153	\$9,041
Dillard's	\$6,675	\$6,411	\$5,691	\$5,516	\$5,408
Stage Stores, Inc.	\$532	\$659	\$686	\$731	\$824
Stein Mart, Inc.	\$410	\$393	\$474	\$519	\$480

*in millions

The size of a firm and its operations is important to the success of a company within a particular industry. In order to be competitive within the department and discount segment of the retail industry, a firm must be large. Large companies have more influence with suppliers giving them the ability to lock in lower prices and prevent intrusion by smaller competitors. Furthermore, large companies have less difficulty attracting customers because they are

capable of offering lower prices than smaller competitors. The above chart shows that J. C. Penney and Kohl's are the largest firms in the department and discount segment of the retail industry. Subsequently, they are also leaders within the segment.

Fixed Assets to Variable Costs

Fixed Assets to Variable Costs Ratios					
	2002	2003	2004	2005	2006
JCPenney	0.2171	0.3147	0.3223	0.3286	0.3445
Kohl's	0.5611	0.5952	0.6554	0.6696	0.7084
Dillard's	0.6414	0.6184	0.6338	0.6300	0.6275
Stage Stores, Inc.	0.2225	0.2757	0.2399	0.2562	0.2542
Stein Mart, Inc.	0.0814	0.0758	0.0663	0.0817	0.1043

*Ratios derived from the financial statements of JCPenney, Kohl's, Dillard's, Stage Stores, Inc., and Stein Mart, Inc.

The ratio of fixed assets to variable costs also plays a very large role in the level of competition in an industry. If a firm has a high ratio of fixed assets to variable costs, the company is locked into the industry. It becomes more costly for a company to cease operations than to continue to operate. If a firm has a low ratio of fixed assets to variable costs, the company has latitude to maneuver itself between industries. If a company discovers that it is not profitable to remain in a particular industry, all it has to do is sell its inventory. Most firms in the department and discount segment of the retail industry have low fixed assets to variable costs ratios. Most firms in the industry use operating leases versus capital leases, which increase fixed assets, allowing them to easily exit the industry should profitability fall. Above are the fixed assets to variable costs ratios for the five firms used in this comparison. The low ratio represents

the number of dollars of fixed assets the company possesses to every one dollar of variable costs the company expends.

Excess Capacity

Comparable Same-Store Sales Growth

	2002	2003	2004	2005	2006
JCPenney	2.8%	0.8%	4.9%	2.9%	3.7%
Kohl's	5.3%	(1.6%)	0.3%	3.4%	5.9%
Dillard's	(3.0%)	(4.0%)	(1.0%)	0.0%	1.0%
Stage Stores, Inc.	1.6%	(4.1%)	2.5%	5.4%	3.5%
Stein Mart, Inc.	(0.8%)	(4.7%)	9.1%	0.2%	(1.2%)

*Percentages from the financial statements of JCPenney, Kohl's, Dillard's, Stage Stores, Inc., and Stein Mart, Inc.

Excess Capacity occurs when supply exceeds demand. In this instance, firms are forced to cut prices in an effort to increase sales volume and reduce inventory. Excess capacity is at a relatively controllable level for larger firms like J. C. Penney and Kohl's in the department and discount segment of the retail industry; however, smaller firms have a more difficult time competing in this area because of less pricing power. Nonetheless, firms are able to monitor and control inventory, as well as same-store sales, shown above. If a store is not profitable, firms in the industry can transfer or sell the stores inventory and close its doors.

Exit Barriers

Exit Barriers are any obstacles that might prevent a company from leaving a particular industry. A high fixed assets to variable costs ratio or legal ramifications are examples of exit barriers. Firms within the department and discount segment of the retail industry do not face any significant exit barriers.

If a firm wishes to shut down, it merely has to sell its inventory and cancel its operating leases.

Conclusion

The department and discount segment of the retail industry is highly competitive. Firms must effectively manage their supply chains and develop smart merchandising strategies to remain successful. The industry is plagued with slow industry growth, little differentiation of products and services, low switching costs, and few exit barriers. These factors lead to the intense competition among existing firms.

Threat of New Entrants

The department and discount segment of the retail industry is highly concentrated and comprised of a few large competitive firms and many small less competitive firms. Successful department store chains have a long history because they have found ways to thrive in a fairly stagnant industry. This makes it especially difficult for new firms to enter the retail industry. For instance, J. C. Penney has been operating for over 100 years and has decades of experience that create massive hurdles for new entrants to overcome. These hurdles include economies of scale, distribution and supplier relationships, as well as some legal barriers. Because of strategic positioning among mature companies, a new entrant's survival is very unlikely.

Economies of Scale

Firms that obtain the right amount of start-up capital can enter the industry, but their survival is slim because of the high concentration of existing firms. When dealing with large companies, small firms are unable to purchase large quantities of products and distribute them efficiently throughout the nation. Finding substantial investment in capital is difficult for new firms because they

typically lack customer base and brand loyalty. This is just one reason for failure in this highly competitive market. Another reason existing firms have an advantage over newcomers is their economies of scale. They also have more experience in managing distribution channels and inventories, which is crucial to maximizing profits in the retail industry. New stores are unable to lower prices enough to compete with established retailers without taking a hit in their bottom line for many years in the future. These factors give large firms a competitive advantage in all areas of the industry. The chart below shows that the most successful firms in the industry are also the largest.

Total Assets

	2002	2003	2004	2005	2006
JCPenney	\$17,867	\$18,300	\$14,127	\$12,461	\$12,673
Kohl's	\$6,315	\$6,698	\$7,979	\$9,153	\$9,041
Dillard's	\$6,675	\$6,411	\$5,691	\$5,516	\$5,408
Stage Stores, Inc.	\$532	\$659	\$686	\$731	\$824
Stein Mart, Inc.	\$410	\$393	\$474	\$519	\$480

*in millions

Distribution Access and Supplier Relationships

One of the biggest problems for first time firms entering retail industry involves supplier relations. Large firms have well established relationships with their suppliers, creating a loyalty issue, which they use to their advantage. Large companies receive price breaks and discounts for buying often and in bulk. New competitors do not possess the networking experience that veterans do upon initial entrance into the retail industry. New firms' limited access to distribution and suppliers is demonstrated by the lack of new companies opening department store in malls across America.

Legal Barriers

Many industries have legal barriers to entry, but the retail industry is one that has few if any. Some problems a new entrant might face could be with importing goods from foreign countries. Problems might arise if foreign companies have requirements importing laws, currency exchanges, or if the producers businesses have legal practices written in their contracts. Some other legal issues all firms face are those dealing with civil suits. Some examples could include civil rights incidents, customer or employee accidents on company property, and loss prevention suits. These are all general occurrences that could happen within any company's practices, but all aspects must be taken into consideration.

Conclusion

From the previous discussion, it is obvious that there are many threats that new entrants face when entering into an established industry. In retail, companies must consider the larger companies and their established competitive advantages, like economies of scale. These advantages leave the new entrants with little chance of successfully entering the industry. Moreover, preexisting buyer/supplier relationships play a huge role in the retail industry and put new entrants at a sizeable disadvantage. Lastly, firms must ensure all legal issues are addressed, no matter the size. Legal issues are a major factor when entering an industry because a new firm could potentially violate laws and treaties that will result in expensive litigation or closure of the business.

Threat of Substitute Products

Within the department and discount segment of the retail industry, a threat of substitute products will always be present. Since J. C. Penney's target customers are mid-income families, there is a moderate threat. Because all merchandise carried by departments serves the same purpose, the switching

cost of buyers can be perceived as low. However due to certain branding and exclusivity, a product increases in value. Middle-income families want to receive this value but at an affordable price that stores such as Nordstrom's cannot offer.

Buyers' Willingness to Switch

Substitute products remain the largest threat when dealing with retailing. Consumers have different wants, which they hold highly in their shopping experience. If a retailer lacks what the consumer desires, the customer is likely to switch retailers. Buyers have many options when switching between department stores. This is why it is very important for J. C. Penney to know their target customers and be able to satisfy their needs. Many consumers are not willing to shop around for the lowest price because of the inconvenience and lower quality of products. Likewise, many consumers are not willing to pay premium prices for products of similar quality that has a more recognizable brand name. The fact that buyers have a low switching cost is a driving factor that retailers must focus on at all times. Department stores know maintaining a strong customer base is what drives the industry. This forces the retailers to cater to the customers taste and preference.

Relative Price and Performance

Consumers perceive value in price. When an item is priced too low, consumers believe they are receiving a low quality product and vice. However, there comes a point when some consumers no longer perceive value in pricing, but rather equate high prices to brand image. For example, if a customer thinks that a product is worth X amount of dollars, anything paid above that price is strictly a premium for the brand. While customers at J. C. Penney care about image, they are more concerned with the comfortable relationship created with specific brands that are perceived as a certain level of quality. Instead, J. C. Penney's customers care about value and realize that you can find it at a reasonable price. In the retail industry, you must maintain a high quality product

that is available within a reasonable price range. Depending upon what type of retailer, department or discount, the product being sold must sell at a price that the buyer considers rational based on the item and service being provided. This price/performance ideology continues to be an issue that motivates all retailers to stand out above the rest.

Conclusion

Substitutes are easy to find in the retailing industry and this poses the largest threat to all department stores. Companies have a constant concern with creating an environment focused on customer satisfaction. With low switching costs in the industry, firms must focus on maintaining their customer base while trying to steal new customers from their competitors. Retailers are able to do this in many ways, like creating a friendly environment where product pricing is relative to the experience.

Bargaining Power of Buyers

The bargaining power that consumers have on an industry can determine a firm's overall business strategy. Buyers with relatively high bargaining power drive a company to compete on price. When a firm tries to lower their prices, they also have to lower their overall costs of production in order to maintain a positive level of net income. Buyers with a very low bargaining power do not typically affect the way in which a business operates. Buyers cannot force the company to compete on price. Therefore, cost of operating is not as big of an issue for firms to regulate.

The departmental retail industry is comprised of multi-brand stores that provide convenience shopping for consumers looking to buy a variety of items without spending time and money on travel. When a customer would like a specific product, that product is not only the tangible asset in which they would like to own, but buying that product also includes an entire package of costs.

These costs include issues such as paying for gas, the travel time spent from moving from one place to the other, and the ease at which an individual can achieve comparative pricing.

Because the average consumer would like to be able to incur these costs at a minimum, most avid shoppers head to the nearest mall for Saturday outings with friends and families. In turn, this creates moderately low switching costs in respect to the department store in which the customer decides to spend their disposable income on any given day. This is important the companies we will discuss in future portions because most of the direct competition in this business deals with department stores that serve as anchors to local malls. Therefore, buyers in the department store retail industry have a very high power over the firm. As we look ahead to consumer price sensitivity and relative bargaining power, we discuss this in more detail.

Price Sensitivity

Price sensitivity of a customer is just as it sounds—it relates the price the average customer will pay in respect to the perceived value of the item. Value is given a price by patrons of the industry, which includes variables such as the costs of expanding effort into locating specific items, the importance of the actual item to specific consumers, and their actual price at which comparable brands are offered. Since items located within these stores are essential to everyday living—such as clothing, linens, house wares, bath items—they are relatively easy to locate at most places. Customers are attracted to one store and not another because of lower prices or step-above-the-rest quality found at different stores.

Companies in the industry including Kohl's, Stage Stores, and J. C. Penney, as well as many others create private brands and product lines with patents and trademarks to instill this sense of quality into their products. They have also utilized brand positioning to increase customer awareness of each of their private label items in each specific store. As the average customer looks

across the board, the power to choose where to shop is ultimately a decision made when answering the question: Where can I get more “bang” for my buck? The response to this is a simple estimation of perceived value to the customer. If any one store in the business does not keep price sensitivity in mind, they will lose out to their share of the pie in respect to profits. Here, the customer wins in this industry.

Relative Bargaining Power

Relative bargaining power of consumers is determined by the level of switching costs that a customer has and the effect that switching to another retailer would have on the company. Customers of department retail stores typically have very low switching costs. They do not lose anything by simply shopping at a different store with the same general items. Companies must offer incentives to lure in customers to spend their money at a particular store. Even though there are a large number of buyers and the volume of purchases per individual consumer is relatively low, this is an industry in which “the customer is king.” If customers move to different locations for their shopping needs, the store in which they are no longer being a patron becomes the biggest loser. Therefore, consumer’s relative bargaining power in this industry is very high.

Conclusion

There are a number of factors contributing to the degree of how much bargaining power a company’s customer base has over the industry. The most obvious factors in which the companies compete, again, are price sensitivity and relative bargaining power. Players in this particular industry must consider these things when developing an overall strategy.

Bargaining Power of Suppliers

The degree of bargaining power of a firm's suppliers has a huge effect on how a company operates. High bargaining power of suppliers causes a firm within the industry to be locked down to mostly one or just a few potential suppliers of their products. These suppliers can be the ultimate decision-makers on what prices and costs a company has. If a supplier with high bargaining power has certain demands, such as higher costs or more flexible delivery times, the firm has to abide by these demands to continue the supplier relationship. Low bargaining power of suppliers causes the firm to have higher power in relation to demands. For example, they can cause their suppliers to come down on prices and have a set delivery schedule or lose their business.

Suppliers for the departmental retail industry generally have very little bargaining power. Many suppliers provide small amounts of inventory regarding the stores general items. However, industry majors such as Stein Mart, J. C. Penney, and Dillard's carry exclusive brands at their stores. This causes the bargaining power of these suppliers to be higher than those providing them with just the basic general merchandise they carry. Combine the bargaining power of these two classifications of suppliers, then the overall bargaining power of the departmental retail industry's suppliers sits at a moderate level. More detail into these two types of suppliers and their bargaining power is discussed in the following sub-sections.

Price Sensitivity

The price sensitivity of a firm in relation to its supplier is an important factor in determining which suppliers to use. The majority of suppliers for the departmental retail industry compete with one another based specifically on price. The products must be low in price while maintaining quality. As with the power of customers, switching costs are huge contributors as to the degree of bargaining power a supplier has over the industry as well. The lower the

switching cost for a company to change suppliers, the lower the bargaining power of those suppliers. The higher the switching cost incurred, the higher the bargaining power.

Many suppliers exist in the industry for firms to choose from for general merchandise; therefore, switching costs for the firms are relatively low. Because of the vast number of suppliers of general merchandise, there is an extremely low bargaining power over the industry. Firms can easily get the same products, same quality, but with a cheaper price tag from a different supplier. It is observed that suppliers of the departmental retail industry have a very low bargaining power of firms within this particular industry.

Relative Bargaining Power

The relative bargaining power of suppliers deals with the degree of differentiation of their products and the presence of substitutions within a particular industry. If a product is highly differentiated and there is a low level of substitutions, then the relative bargaining power of the supplier is high. If a product is similar to others and there is a high level of substitutions, then the relative bargaining power of the supplier is low.

Many of the companies within the industry have fought to create brand image into their inventories. Because they have decided to differentiate some of their product lines, the bargaining power of their suppliers tends to be at a moderately high level. Companies within the industry such as Dillard's, Stage Stores, Inc., and J. C. Penney have all implemented the use of patents and trademarks on popular brand-named merchandise. For example, Dillard's holds contracts with companies such as Estee Lauder, Gianni Bini, and Jones New York (www.dillards.com). Stage Stores carries brands from suppliers such as Chaps Ralph Lauren, Elizabeth Arden, and Tommy Hilfiger (Stage Stores, Inc. 2007 10-K). J. C. Penney holds contracts with Bisou Bisou, Chris Madden, and Sephora (www.jcpenney.net).

The relative bargaining power of these suppliers are high because they define the type of company that these department stores aspire to be; companies where consumers can purchase quality, name-brand items at prices that they can afford. In the same way that these stores need these brands to bring customers in, the popular brands themselves need an outlet to create more cash flow through the sales in department stores. This is why there is a moderate bargaining power of suppliers over firms.

Conclusion

The bargaining power of both consumers and suppliers has a huge effect on the way a company gains and maintains its competitive advantage over its competition within an industry. The switching costs among customers tend to be relatively low in the departmental retail industry causing their bargaining power to be elevated. However, since many firms within this industry are trying to differentiate their products, the bargaining power of the consumer falls at a moderate level. The switching costs for the firms relative to their suppliers are generally at a very low level. Many suppliers carry and provide much of the same merchandise to these companies. Because these firms are differentiating, the bargaining power of these suppliers tends to be at a higher level. This is why the overall bargaining power of the suppliers of departmental retail companies is at a moderate level as well.

Value Chain Analysis

The Overall Classification of the Industry

To recap, the retail industry segment in which J. C. Penney competes is classified as having the following attributes: high rivalry among existing firms, a low threat of new entrants, a high threat of substitute products, a high bargaining power of buyers, and a moderate power of suppliers over the firm. Many factors come together to lead this group to these conclusions. The most important factors are a mix of slow growth in a highly concentrated industry, high economies of scale, established distributor relationships, customer's willingness to switch to different products, and price sensitivity to these products. Firms competing within this industry obviously must focus on several factors in order to be successful and achieve profitability.

As we classify these many ingredients to a successful company into key success factors, focus is put on cost leadership versus specialty differentiation. For the most part, the company must focus on cost leadership as their main strategy; however, they must also have a degree of differentiation to achieve full profits. Usually, companies must choose to follow one success factor or the other, but in the case of this industry, a smart mix of the two is key to achieving the competitive advantage.

Companies, in order to compete within their industry, are involved in different sets of activities to add value to their products. Through the value chain, a generic product gains value by different inputs and strategies required within the industry. "The goal of these activities is to offer the customer a level value that exceeds the cost of the activities, thereby resulting in a profit margin" (www.netmba.com). By analyzing the value chain, individuals can gain an understanding of the key success factors needed within an industry. In addition to this, they can look at a company and verify if these competitive strategies are needed where applied.

Competitive Strategies

In order to achieve this industry strategy, retail department stores must take advantage of economies of scale and scope, lower input costs, and obtain tight cost control systems within the cost leadership approach. To appease customers need for quality and style, retail department stores must use several factors within the differentiation approach as well. They must focus on product quality and variety, invest in brand image, and invest in some research and development to ensure the latest fashion has been obtained.

Economies of Scale and Scope

The high competition of retail department store industry forces companies to focus on cost. Economies of scale refer to the situation in which a company in the long run reduces cost of selling a good by increasing purchases. Size of stores and availability of products is beneficial to achieve economies of scale. By focusing on carrying the same items at every location and taking advantage of channels such as catalog and internet sites, companies can make their products widely available. This could not be done without having a centralized unit to maintain the lines of communication especially at a large scale. Economies of scope, on the other hand, though a similar concept relates to demand side changes. According to investordictionary.com, "economies of scale refer primarily to supply-side changes (such as level of production); economies of scope refer to demand-side changes (such as marketing and distribution). Economies of scope are one of the main reasons for such marketing strategies as product bundling, product lining, and family branding." Due to the high competition in this industry, department stores must familiarize their customers with their brands. This will help reduce the amount of advertising that must be done to be memorable. Customers will familiarize and relate to these brands and come back looking for new items whenever needed.

Lower Input Costs

In order to maintain affordable prices and receive a profit, input costs must be lowered within the retail department industry. This is an extremely large task when considering the quantity and diversity of supply within a department store. If this is achieved though, it will increase profit because most of the inventory will be sold at the price needed to receive at a minimum the required rate of return. Excess inventory forces department stores to have discounts and at worst put items in clearance where the department store will break even if not lose money. Another component is maintaining a close relationship with suppliers enabling the cut of costs. Suppliers give discounts to large quantities of items sold because of high fixed to variable costs ratio. It is profitable to both companies to establish a relationship and maintain it for a long period of time. In addition, as most companies in the United States are practicing today, it is cheaper to outsource from foreign companies to manage costs. This has not become an option in our industry but a demand.

Tight Cost Control System

All competitive strategies within the cost leadership focus come down to having a tight cost control system in order to be successful. Without establishing a cost control system, every other minimizing cost strategy will ultimately fail because a competitor with this system in place will be able to beat the rest of the competitors out of the market by lowering price and maintaining a profit. This can only be achieved by having a company structure that benefits the operations. This can be achieved with plans such as distribution centers in accessible locations for the stores in order to drive costs down and receive merchandise at a reasonable time. Also, maintaining the same setups and inventory selection within all company stores. Furthermore as mentioned earlier, outsourcing is a demand that must be met in order to minimize costs within the retail industry.

Department stores have to focus on cost leadership strategies in addition to several differentiation strategies to set themselves apart to be profitable. The retailing department industry has realized that though price will always be a factor, quality is demanded more often. By focusing on strategies such as economies of scale and scope, lower input costs, and tight cost control systems, department stores will be able to drive costs down. To reach the level of quality customers demand a focus on product quality and variety, investment in brand image, and investment in some research and development will also be needed. This is the only way a department store can ensure profitability from customers that want affordable prices with quality clothing and have a profit to continue succeeding in this high competitive retailing department industry.

Product Quality and Variety

Retail department stores as an industry compete against one another as many multi-brand outlets. As previously mentioned, companies in this industry must maintain cost controls in order to maximize profits, but this alone does not win customer favor. Each company must differentiate from one another in respect to these different brands to bring customers in to their store rather than to the "other guy's." Companies do this by selling private labels in stores and online, "which in some cases account for as much as 70 percent of the total merchandise in the outlet" (Expresstextile.com). These private brands create a strong value proposition for the company and a healthy demand for product with some brand loyalties. This industry offers a wide range of product, including personal brands consisting of quality merchandise at affordable prices. This is important because as prices rise in our economy today, such as issues of oil and gas prices, there is lower the demand for higher quality products in middle-income households. As these families have less to spend on luxury goods, brand loyalty and affordability begin to take a key role in consumer choice.

Investment in Brand Image

Not only do private brands help differentiate one store from another, but retailers also contract with popular product labels to sell merchandise exclusively with their specific company. Contracts such as these bring consumers into the store to purchase product lines of these specific labels, luring them into an environment in which there are many choices and point of sale items on display. This encourages more spending by these customers and creates the possibility a wider variety customer base. With the choice of private product lines specific companies create and carry as well as popular brands that have been contracted out, customers have many choices within different department stores.

Investment in Research and Development

In the retail industry, following fashion trends is important in order keep up with consumer needs and wants. Focus on new ideas and continuous change in development is a key success factor to maximize profits by keeping customers happy and eager to see what the industry has to offer. Companies must continue to research customer feedback and implement ideas into current strategies to maintain advantage over competitors. This is important because customer opinion helps to direct the fashion industry into the next trends that succeed within private brands owned by companies.

Another trend retail department industry must focus on is the whether consumers prefer a mall shopping experience or stand-alone stores. "Mall retailers currently account for about 16.6 percent of total retail sales, down from 17 percent last year and about 38 percent a decade ago, according to Customer Growth Partners" (O'Connell, Wall Street Journal). Overall in the highly competitive department store industry, research and development is a continuous task needed in order to retain consumers and profitability.

The Big Picture

Players in this industry have many factors on which to focus to stay ahead of the competition. The goal of these companies is to create added value through proactive managing of key success factors while growing the company toward future visions. A mixture of cost leadership and differentiation through product brand identity is the ultimate guideline to achieving maximum profits. Such a strategy included tactics in cost leadership economies of scale and scope, keeping input costs low to minimize cost and maximize profits, and cost controls on inventories and overhead.

To keep the customer coming back, not only did the price need to be right, but also the product distinct and attractive. Companies must continue to push product variety in private brands, invest in a positive brand image, and continue to research new trends in fashion to keep customers interested in products. Each company will adapt to certain qualities in a fitting approach to individual business models; however, the company that continually finds the best fit in the changing economy, while keeping the willingness to change, will ultimately prevail.

Firm Competitive Advantage Analysis

J. C. Penney has just finished a five-year turnaround plan to increase profits and gain market share. This could only have been done by focusing on the competitive strategies within the departmental retail industry. J. C. Penney has focused on strategies such as economies of scale and scope, low input costs, and tight cost control system to remain price competitive. In addition to this, it has also invested in product quality and variety, in brand image, and in research development to differentiate itself from the rest of the industry.

Economies of Scale and Scope

J. C. Penney has achieved economies of scale by becoming a centralized unit holding the same inventory. Now, J. C. Penney is in a large campaign of expansion by expecting to open approximately 50 new stores per year from 2007 through 2009. This will give them an even larger advantage with such a high growth from its already large retail size of 1,033 department stores in 49 states. In addition, its Direct channel holds its internet and catalog information. J. C. Penney's competitors such as Kohl's, Dillard's, Stage Stores Inc., and Stein Mart are much smaller. This is a huge advantage for J. C. Penney because it enables it to purchase large quantities from its suppliers and receive it at a bargain price in order to produce a larger profit after sales. J. C. Penney has taken advantage of economies of scope by launching private and exclusive brands. This has helped J. C. Penney position itself as a provider of high quality products and services at affordable prices. In addition, the consistency of merchandise within the stores, internet, and catalog drives costs down, while high advertising exposure is already in place.

Lower Input Costs

J. C. Penney is attempting to keep inventory levels at a healthy level by keeping a good balance between fashion and basic merchandise. The company has been successful because it recognizes sales trends faster, and it quickly replenishes individual stores with a high rate of sales. J. C. Penney does this by continually managing and regularly updating the computer systems that help to track its inventory. Advances in technology help the company to send this inventory information to suppliers, which in turn results in quicker replenishment of inventory without a surplus of inventory during any given period.

	2002	2003	2004	2005	2006
Inventory Turnover	3.8	3.49	3.21	3.28	3.33

As the table above indicates and as is illustrated in J. C. Penney's annual report, there has been some improvement within inventory management from the prior years. This helps J. C. Penney cut out unnecessary expenses in order to be able to maintain quality items with affordable prices so the target customer is reached.

J. C. Penney has numerous suppliers that it has done business with for many years. This is very important because it forms a bond to enable both sides to profit from by lowering costs of production, and this enables J. C. Penney to receive merchandise at a lower price. In addition, J. C. Penney out sources a substantial amount of production to foreign manufacturers; this helps the company buy products at lower costs and yet maintain quality. In fact, all of J. C. Penney's suppliers for its exclusive and private brands, regardless of being foreign or within the U.S., have their manufacturing centers outside of the United States.

Tight Cost Control System

J. C. Penney, during implementation of its turnaround plan, realized that something had to be done about its cost control system in order to reach the target customer. J. C. Penney had a decentralized system with branch managers in charge of displays and available inventory. This has changed to a standard floor design and product layout for consistency across many stores and reduces costs in the long run. In addition, J.C. Penney now has thirteen key distribution centers to lower the cost of distribution and increase accessibility. The centers have the ability to reroute orders and deliveries.

Another way J. C. Penney has reduced costs has been by finalizing installations of POS (Point of Sale) systems within all stores. This helps make quicker transactions, and it also connects all stores via the internet to keep a running count of all inventory at all times. This helps the stores in many ways. For one, the inventory POS system reduces the amount of staff needed to make the sale to customers due to a quicker transaction, which in turn drives down costs of labor. Also, knowledge of amount of inventory helps J. C. Penney keep a semi-accurate count all products on hand, disposing the idea of excess inventory that creates waste. Finally, as mentioned earlier, J. C. Penney has foreign suppliers as they outsource all private brand merchandise from both its foreign and domestic suppliers, which also helps to reduce the cost of purchasing supplies.

Operating Expenses over Sales

	2002	2003	2004	2005	2006
Operating Expenses/ Sales	.98	.97	.94	.92	.91

The table above shows how J. C. Penney has been successful in maintaining tight cost controls in the last five years. As one can see, the amount of operating expenses per dollar made in sales has been reduced by seven cents

in the last five years. This trend will more than likely be reduced even more now that the implementation of the POS systems has been established in all locations this past year.

Gross Profit Margin

	2002	2003	2004	2005	2006
JCP	0.3076	0.3722	0.3875	0.3927	0.3932
KSS	0.3442	0.3302	0.3516	0.3554	0.3637
DDS	0.3805	0.4583	0.5007	0.5305	0.5188
SSI	0.3029	0.2876	0.2891	0.2912	0.2925
SMRT	0.2474	0.2514	0.2664	0.2809	0.2773

Product Quality and Variety

J. C. Penney offers a wide variety of brands and product in its stores and online. Many of these brands have been created as private brands through J. C. Penney “as response to feedback from customers and research of direct competitors” (J. C. Penney 2006 10-K). A recent example, according to the J. C. Penney 2006 10-K, is the new private label lingerie brand, Ambrielle. “Ambrielle was created to fill a void in the marketplace for a sensual lingerie brand targeted to the modern customer at a smart price” (J.C. Penney 2006 10-K). This is just one of the many examples of brand creation by the company to bring in a wider range of customers that enjoy style at the right price. At J.C. Penney, the consumer has the choice between varieties of quality goods.

Investment in Brand Image

Not only do private brands bring in loyal customers, contracts with popular brand names also attract other consumers to places they may not usually go. Fans of the popular cosmetic brand, Sephora, will visit J. C. Penney just to purchase these products then “shop around” the store, creating more revenues for the company. J. C. Penney is not only selling Sephora products but is also talking with Polo Ralph Lauren’s Global Brand Concepts. This talk “has recently launched a new lifestyle brand, American Living, created exclusively for

the J. C. Penney customer" (J. C. Penney 2006 10-K). Examples such as these show how J. C. Penney strives to differentiate the merchandise in its stores, creating a mix of product that ultimately stands out to the consumer as superior than the rest. This seems to have ultimately paid off because as J. C. Penney "continues to expand its stable of private brands; (they) now account for about 45 percent of sales" (Covert, Wall Street Journal).

Investment in Research and Development

According the 2006 10-K report, J. C. Penney "has taken several actions to improve the customer shopping experience across all channels, including more closely aligning stores and Direct promotions." An example of how the company has implemented its findings is seen by looking at the a.n.a. brand, which targets working women. This clothing line implements a style that is classy enough to wear during the week but not too formal for the weekend. The flexibility of this line of clothing is what was demanded by the working women of today. J. C. Penney has also responded to the recent demands of the retail industry focusing on expansion within non-mall locations. J. C. Penney's "250 stores it plans to open in the next five years will be stand-alone entities, not connected to shopping malls" (O'Connell, Wall Street Journal).

Looking Ahead

J. C. Penney has repositioned itself within the department store industry to identify with its target consumer, the middle-income family that would like to affordable quality products. To reach this target consumer in more areas as well as maintain a healthy growth rate, J. C. Penney is growing the number of stores in operation. The current agenda for the company is to open 50 new stores per year from 2007 to 2009. This will help the company continue to capitalize on the present advantage of being one of the largest department retailers in the United States with 1,033 departments across 49 states. J. C. Penney is also focusing on the latest idea of opening more locations in places that are freestanding and

convenient for different consumers other than those who shop in malls on a regular basis.

The continuous balancing act between keeping the correct mixture of cost leadership while carrying above average merchandise is an issue that J. C. Penney will have to always need to re-evaluate on a regular basis to sustain the competitive advantage. The company seems to do well at this as they implement new inventory tracking systems while creating and developing private brands.

The image shows the JCPenney logo in white text on a light pink background. The logo consists of the letters 'JCPenney' in a sans-serif font, with a small registered trademark symbol (®) at the end of 'Penney'.

Accounting Analysis

Financial statements are prepared to provide shareholders and other potential investors with a more informative view as to the value of a company. They are designed to answer the fundamental questions of how the business is currently performing and what its future prospects are. By answering these questions, these financial statements offer the company's investors with information needed to make informed decisions, whether it be to invest in the company or finance the firm's future endeavors. The accounting analysis must be done with a healthy level of skepticism due to the flexibility provided by the Generally Accepted Accounting Practices (GAAP). Management has been given this discretion in order to give a more informative and clearer understanding of their company. This leads to estimates and assumptions involving judgment that could lead to some errors. An accounting analysis is a tool used by financial analysts to investigate the extent of these errors. It is used to determine the accuracy of the statements provided by financial managers of a particular firm.

The accounting analysis process consists of six steps. First, the key accounting policies must be identified. These policies are used to measure the firm's key success factors and its potential risks. "A critical accounting policy is a policy for a company of an industry which is considered to have a notably high subjective element, and that has a material impact on the financial statements" (www.wikipedia.com). Next, an assessment of accounting flexibility allowed by GAAP must be performed. Not every company has equal amounts of flexibility when deciding upon which key accounting policies to utilize. Therefore, this flexibility must be looked into and addressed. Once the accounting flexibility is determined, an evaluation of the firm's accounting strategy is conducted. This evaluation determines how consistent the firm's accounting policies are with its competitors. It also looks into the financial managers' incentive base, whether the firm has recently changed or altered its policies, and if any business

transactions have been improperly structured to achieve certain accounting objectives (Business Analysis & Valuation).

The fourth step of the accounting analysis process is to evaluate the quality of disclosure. This evaluation determines the level of transparency that a firm has within its financial statements. The higher the level of transparency, the more accurate the financial statements tend to be. In addition, this transparency allows investors to get a more informative view of the actual performance of the firm. During this accounting quality analysis, potential "red flags" should be identified. They typically are unexplained or unusual changes in numbers reported in the statements. These are alerts that poor accounting quality has been used. Once flexibility, disclosure, and "red flags" have been identified, the analyst must undo any accounting distortions found within the firm's financial statements in order to provide accurate information to the investors.

Key Accounting Policies

A company's key success factors should always be looked at when a firm is deciding upon which key accounting policies to use. This is because these success factors add value to the firm by giving it an advantage over its competition. J. C. Penney's key success factors, as mentioned within the five forces model, are economies of scale, tight cost control, and investment in brand image. Since there is generally not a lot of differentiation between the majority of products sold within this particular industry, firms want to have every advantage possible in order to set themselves apart from their competition. Investing in a company's brand image is another way to gain a competitive advantage within the departmental retail industry. Brand image is about getting your consumers to remember your name and products. However, the cost of getting the word out can be rather high. Keeping costs low is the main way in which a firm can gain an advantage over its competition. Flexibility within GAAP can be used by firms to either clearly disclose their financial information or adjust

their numbers to be more appealing to investors than they would have otherwise. The following are the accounting policies derived from J. C. Penney's key success factors.

Continuous Growth

The high competition of department and discount segment of retail stores forces companies to be cost competitive. Taking advantage of economies of scale, firms can reduce fixed cost by distributing it through a larger amount of purchases. This helps maintain prices competitive without reducing the quality. Having a healthy continuous sales growth helps to achieve this. J. C. Penney has achieved a sixth consecutive year of comparable department store sales growth averaging more than 3 percent increase per year (J.C. Penney 2006 10-K). The table below illustrates the percentage growth for the last five years within the company. Internet sales growth has had a large impact in the firm accounting partially for the turnaround of the direct channels sales growth.

Sales Growth

	2002	2003	2004	2005	2006
Comparable Department Stores	2.6%	.9%	4.9%	2.9%	3.7%
Internet	17.8%	50.8%	34%	28%	22%
Direct (Internet/Catalog)	-22%**	3.3%	3.3%	3.6%	2.4%

* Percentages derived from the J. C. Penney 2006 10-K. ***"In 2002, catalog was impacted by planned lower page counts, lower circulation of catalog books, changes to payment policies and fewer outlet stores" (2002 J. C. Penney 10-K).

Along with these sales growth percentages, J. C. Penney has started accelerating the growth of new stores. It expects to grow 50 new stores from 2007 to 2009. Most of these new store locations opened will be operating or capital leases. J. C. Penney owns 314 department stores as of April 2007. J. C.

Penney does state in its annual reports that “management intends to maintain sufficient cash investment levels to ensure support for... contingency items, such as the opportunistic purchase of selected real estate properties attributable to consolidation within the retail industry” (J.C. Penney 2006 10-K). This shows that J. C. Penney will invest in properties, if the opportunity were to arise, in order to receive higher profits due to economies of scale.

J. C. Penney has both a line item in its income statement for pre-opening expenses and real estate expenses with further explanation within its footnotes. This shows a great amount of disclosure helping to maintain the level of transparency within its annual reports. This is a key accounting policy because it is very hard to have full disclosure during a high growth period whether it is sales, size or both. This information could give insider information to competitors that could jeopardize its strategic moves. J. C. Penney chooses to maintain a high disclosure to keep the shareholders informed regardless of the risk.

Post-Retirement Benefit Plans

Department and discount segment of retail stores, in order to continue operating using its key success factors, must keep costs as low as possible. This can lead to very aggressive accounting policies that will reduce the transparency of their financial statements. A place that can be strongly influenced by this is accounting for post retirement benefit plans. The judgment required to generate the rate of discounting the pension benefit costs to present value can impact the amount tremendously. J. C. Penney shows this by clarifying that “the sensitivity of the pension expense to a plus or minus one-half of one percent of the discount rate is a decrease or increase in expense of approximately \$0.07 per share” (J.C. Penney 2006 10-K). That is a large difference and could either satisfy or dissatisfy shareholders.

Pension Discount Rates

	2002	2003	2004	2005	2006
J.C. Penney	7.25%	7.1%	6.35%	5.85%	5.8%
Dillard's	7.25%	6.75%	6.0%	5.5%	5.6%
Stage Stores Inc.	6.5%	6.5%	6.5%	6.0%	5.75%
Kohl's	N/A*	N/A*	N/A*	N/A*	N/A*
Stein Mart Inc.	N/A*	N/A*	N/A*	N/A*	N/A*

* (discount rates not disclosed)

**Percentages from the company's 10-K's

The table above shows the pension discount rates for the last five years among top five department stores in the department and discount segment of the retail industry. J. C. Penney, along with Dillard's, has become less aggressive with their generated discount rate showing figures that are more transparent; these conservative discount rates help the present value cost amount to be more reasonable compared to the actual expense. J. C. Penney lowered its discount rate "...based on the yield to maturity of a representative portfolio of AA-rated corporate bonds as of the October 31 measurement dates in 2005, 2004 and 2003, with average cash flow durations similar to the pension liability" (J. C. Penney 2006 10-K).

These average discount rates show to outsiders of the industry that J. C. Penney is not worried with large pension costs cutting into its net income. Actually, J. C. Penny has seen a "... decrease in retirement-related benefit plan expenses..." This "...was driven by the \$60 million decrease in qualified pension plan expense, which resulted from strong investment returns on the plan's assets" (J. C. Penney 2006 10-K). Overall, there has been an improvement of disclosure of post-retirement benefit plans within the J. C. Penney annual reports. This high level of disclosure along with the average discount rates used show that J. C. Penney has been able to be confident in its accounting policies along with the key success factors to be competitive within its industry by maintaining costs low.

Operating and Capital Leases

Operating leases are widely used within the department and discount retail store industry. They stay off the balance sheet helping to reduce liabilities, or future obligations, the company may have. This distorts financials and can be very hard to undo because most firms do not disclose lots of information pertaining to these future obligations that generally can be for a large amount of years. The industry uses them because costs seem to be lower than competitors that may use capital leases. They appear to be cost efficient to shareholders. On the other hand, capital leases are leases with characteristics of asset ownership. They are amortized over either the economic life or asset life depending on the amount of years for the lease.

J. C. Penney discloses a vast amount of information pertaining to capital and operational leases. It discloses the future payments for the next five years, the present value of these obligations, and even the discount rate used for both. The obligation amount for both capital and operational leases are not substantial amounts. This helps keep financials without significant distortions especially since most information is disclosed within the footnotes about it, which shows consistency with its level of disclosure. Overall, the level of disclosure and the way they account of operational and capital leases is an important accounting policy to J. C. Penney because of the potential changes it could have to the presentation of expenses and costs. This is very important in this industry of cost competition to maintain the shareholders as informed as possible especially with its strategic growth that may increase its amount of operational and capital leases.

Research and Development

With the new focus of J. C. Penney to reposition itself as not only affordable prices but also quality to target customers, a lot research and development has been spent for differentiation. Expenses have occurred in things such as brand development, quality control, and advertising. In the past,

companies have erroneously capitalized these costs as an asset of the company to maintain net income at an acceptable level. This is incorrect and is a policy that must be looked on carefully.

J. C. Penney's high disclosure annual reports show that these costs are expensed as incurred, as they should be. Brand development and quality control costs are expensed within cost of goods sold. This is because these are costs "directly related to bringing merchandise to its final selling destination" (J. C. Penney 2006 10-K). Advertising expenses are included within selling, general, and administrative costs and are expensed when the advertising occurs for the first time or as incurred.

This accounting policy is very important when part of the firm's key success factors is through differentiation. High costs may be incurred, and it is very tempting to capitalize them as assets since they may seem to bring future value to the firm. This is an error because the future benefits cannot be calculated. Because of J. C. Penney's high disclosure, an outsider is able to verify that J. C. Penney expenses these costs as they do.

Conclusion

As more attention is shed upon firm's that use creative accounting to manipulate numbers in its favor, key accounting policies become factors that are even more important to identify and look at carefully. The only way to ensure the firm's key accounting policies and receive a clear understanding is by having transparent annual reports with high disclosure. These policies should support the firm's success factors in order for a company to be profitable. The key accounting policies supported J. C. Penney's key success factors of economies of scale, lower input costs, tight cost control, and investment in brand image. This can be verified by looking at the transparent financial statements and high disclosure footnotes that ease the process of verifying.

Potential Accounting Flexibility

A firm provides financial statements in order to give investors the information they need to make informed decisions regarding its investments within the firm. This information should be relevant, reliable, and consistent. Flexibility within GAAP allows financial statement preparers the opportunity to present their company's financial information in a more informative, qualitative way. This flexibility, however, can cause some information in a company's financial reports to be distorted, making it seem more appealing to potential investors. Some of the ways in which J. C. Penney has flexibility within GAAP are discussed below.

Operating vs. Capital Leases

One of the main accounting policies that J. C. Penney has flexibility in is whether to classify its leases as either operating or capital. With an operating lease, the owner of the building or property only leases out the right to use it for operating a business. When the lease term is up, the lessee can either return the property or renew his or her lease for an extended amount of time. Since ownership does not transfer from the lessor to the lessee, the rent expenses are only reflected on the income statement (as operating expenses) and not on the company's balance sheet. When these expenses are not listed on the balance sheet, the company's assets and/or liabilities can be significantly understated. This in turn causes the firm's expenses to be understated, the net income to be overstated, and the firm's retained earnings to be overstated. When the retained earnings of a company are overstated, it appears more profitable than it truly is. When a firm appears to be highly profitable, shareholders are more inclined to invest in the business.

Capital leases, on the other hand, do affect the firm's balance sheet. They are listed as both a liability (lease payments) and an asset (additions to PPE). This is because the lessee assumes risks (e.g. taxes, payments) and also

acquires certain benefits associated with ownership (e.g. depreciation, deduction of interest expenses). Since these expenses are recognized sooner than later while using capital leases, most departmental retail firms opt to use operational leases instead. However, since the obligation amounts of both of these types of leases are relatively low for J. C. Penney, the company has a lot of flexibility when choosing which type of lease to apply to its financial reports.

Pensions

Pensions, or post-retirement benefit packages, represent a significant financial liability for a firm. Flexibility within GAAP allows from many companies to overstate their earnings therefore making adjustments for pension expenses. Companies determine how much they will have to spend in the future on retirement packages based on their employee base. These assumptions include things like the overall age and expected retirement dates of their existing employees. When a final number is decided on, the rates are discounted back using the time value of money so that they have a present value for these future expenses. The lower the discount rate, the higher the company's assets because there is less money going into this type of expense. With increased assets, there is typically a higher rate of return for the firm. Reporting a higher rate of return on assets means a higher profit and therefore a greater percentage paid out as dividends to the investors. Fortune Magazine states that "a reasonable rate of return on pension assets is between 6 and 7 percent." J. C. Penney has maintained a limit around this reasonable rate. Therefore, they have flexibility with regard to what discount rate they utilize and still be within a normal range.

Conclusion

Flexibility within the generally accepted accounting procedures allows firms to report their financial information to their investors in more detail. However, firms can utilize this flexibility to distort and manipulate their financial statements in order to make their company appear more profitable than they

truly are. J. C. Penney, however, has a relatively high level of disclosure within its financial reports. Therefore, they use the flexibility allowed to them while maintaining a certain level of transparency for their investor information.

Actual Accounting Strategy

Financial statements produced by companies are given a certain level of discretion when creating their financials in accord with GAAP. They have the option to make their documentation appear aggressive, conservative, or a mixture of both. In using this leeway to their advantage, firms can manipulate their performance to give a good economic understanding or hide the actual performance of the company. After reviewing J. C. Penney's previous financial statements, it appears they have chosen to show both aggressive and conservative documentation.

Some form of retirement plans are available through all department retail stores. J. C. Penney has a defined benefit pension plan that is offered to all employees after 1 full year of service or 1,000 hours of work. With these plans come many assumptions that require significant judgment. "The Company utilizes third parties, including actuarial and investment advisory firms, to help evaluate the appropriateness of the expected rate of return, the discount rate and other pension plan assumptions annually" (J. C. Penney 10-K 2006). Using an outside source to help find estimations gives JCP a fair assessment of what rates to state within their financials. As mentioned previously, J.C. Penney's pension discount rate has decrease substantially over the past five years from 7.25 to 5.8 percent. Investopedia.com claims that a lower the discount rate used on pension cost/expenses will cause the overall cost of these expenses to increase (www.investopedia.com). From this point of view, you could state this lowering of rates as a conservative action of these firms. As shown in the previous graph, this has been an industry wide change over the past five years. This had little change on the recording of pension expenses for J. C. Penney; in

2006, they made several changes to their recognition of defined benefit plans. The changes should have a stronger showing on the 2007 financials, but no substantial changes that would affect the company's statements.

Most department store retailers have a large amount of operating leases on their books, and J. C. Penney is no different. They have a substantial amount of operating leases amounting to a present value of \$944 million, while holding only \$8 million of capital leases on record. Firms choose to record these leases as operating because, "the lessee does not assume the risk of ownership, the lease expense is treated as an operating expense in the income statement and the lease does not affect the balance sheet" (Capital Resources, www.cr-ny.com). This is considered to be an aggressive accounting technique, but one that most retailers disclose in their financials.

J. C. Penney offers many allowances through different programs in order to maintain good relations with their suppliers. These practices include discounts on advertising, markdown reimbursements, and for defective merchandise, all of which require specific conditions for their allowance or repayment. Such as for use when recording markdowns, when reimbursements are encountered with merchandise that has been sold, the loss is directly related to the cost of goods sold for the period encountered. In the case that allowances are encountered with the vendor before the merchandise is sold, the record is documented with association to the merchandise cost. This technique would be considered somewhat conservative, and as well an industry standard practice.

Quality of Disclosure

The quality of communication between the company and those who study the financial position or direction of the company in respect to annual reports is crucial in determining the confidence of those outside the company looking in. The following sections discuss the worth of the J. C. Penney's annual reports in both a qualitative and quantitative perspective.

Qualitative Analysis of Disclosure

The quality of disclosure relating to the footnotes and discussion should be the best the company can offer to the public without giving competitive secrets away. It is important for analyst to believe they are receiving the best information they can so that these people have confidence in the company's direction and guidance. Having a confidence in a company form the shareholders helps to shed positive light on future projects with eager skepticism rather than suspicion. Assurance of these statements is achieved by how well the company speaks about what is happening in the financial statements.

Pensions

J. C. Penney does a very good job in relaying information of current happenings regarding new brands and product lines as well as financial positioning and reasoning. One example of how the company strives to be as transparent as is the manner in which J. C. Penney shares information on pension plans. This particular subject is one of interest to the investing community because this is an area that companies have the flexibility to distort financial statements and mislead analysts' beliefs of their financial positions. J. C. Penney tries very hard to give all the information possible to create a clear picture of where the numbers on the financials come from. Not only is there discussion of pension plan benefits and contributions in the manager's discussion and analysis section the 2006 10-K, but the company also provides a very detailed section in the appendices of how exactly the number materialize.

Within all eight pages of discussion and proven numbers, J. C. Penney goes into detail on issues such as who is allowed to receive benefits, primary and supplemental plans, expenses of such plans, how they are funded, and the actual discount rates of all plans. Unlike some companies in the industry, J. C. Penney discloses the discount rates of the plans, saving analysts the trouble of

backing into them through crunching the numbers. Overall, the level of disclosure in respect to pensions is impressive in relation to industry competitors.

Sales Breakdown

Another manner in which the quality of the supplemental information of the financial statements is helpful is the way the company breaks down the percentages of sales of the different departments in the stores. On the following page is a chart extracted from the J. C. Penny 2006 10-K.

Retail Sales Mix			
The following percentages represent the mix of consolidated net retail sales:			
	2004	2005	2006
Women's apparel	23%	22%	22%
Home	21%	22%	21%
Men's apparel and accessories	20%	20%	20%
Children's apparel	11%	11%	11%
Women's accessories	9%	10%	10%
Family footwear	6%	6%	6%
Fine jewelry	5%	5%	5%
Services and other	5%	4%	5%

This example of information is important because it shows a breakdown of the sales of each department. As you look at the table, you can see why J. C. Penney has focus on women when it comes to new brands and product lines, such as the new lingerie brand Ambrielle. Information such as this helps people understand the direction in which the company is heading, and why J. C. Penney has chosen to move in that direction. In the case of the J. C. Penney Company,

we can see why targeting the strong purchasing power of women in new private and exclusive brand launches is beneficial to the bottom line.

Seasonal Business

Not only do the sales of different departments matter to investors, but quarterly results as well. Usually large sales and profits in the fourth quarter raise large red flags for potential distortion and manipulation. In the retail industry, however, the fourth quarter results are comparably larger than previous quarters because of the holiday season, including “black Friday” and Christmas shopping. In the manager’s discussion of the 10-K, J. C. Penney addresses this issue and explains why many factors depend on last quarter earnings.

While many would like to believe this is the only case in which earnings may severely fluctuate, analyst must remain skeptical of the numbers. The quality of reporting across the industry is low, so the average reader would assume this is not a subject in which to be alarmed. Because many of J. C. Penney competitors disclose close to the same information on fourth quarter results, we take this as a norm.

Conclusion

As a whole, the quality of footnotes and discussions seem to be very detailed and clear in explain where numbers came from as well as why they are what they are. Compared to years past, it seems as if the information the J. C. Penney Company discloses gets to be more detailed with each new annual report. We believe that this is due not only to more regulated accounting practices, but also because the company is improving with time. After careful analysis, we believe the company does an overall fair job of keeping all informed of business activities.

Quantitative Analysis of Disclosure

Generally Accepted Accounting Principles (GAAP) provide managers with flexibility. This flexibility is valuable because it allows managers to better portray the performance of their firms through the financial statements. In addition, this flexibility helps managers to create a clearer picture of the financial health of the company. However, since there is incentive for managers to distort a company's actual performance, it is important that analysts, regulators, and investors, alike, carefully scrutinize the numbers contained in those statements. Any significant change in the numbers represented in the financial statements should be thoroughly investigated.

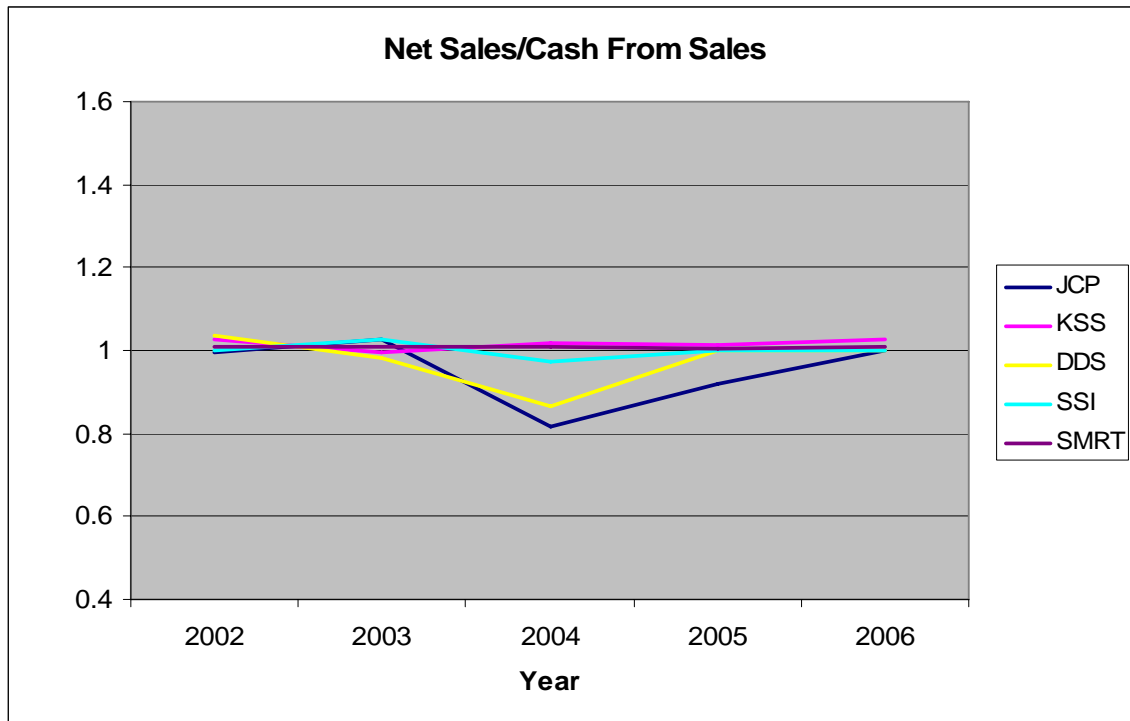
Two categories of diagnostics utilized here to help better evaluate the revenues and expenses of a firm are sales manipulation and expense manipulation diagnostics. Comparing net sales to cash from sales, accounts receivables, inventory, unearned revenues, and warranty liabilities over an extended period, in this case five years, can aid analysts in pinpointing accounting irregularities used to puff up performance. Like wise, comparing expenses, cash flows, accruals, and asset turnover from one year to the next can help identify inappropriate manipulation of reported information. Unexplained increases or decreases in any of these ratios may be a "red flag" that could potentially expose a serious financial health problem, improper accounting practices, or even fraud.

Sales Manipulation Diagnostics

Examining the sales performance of a company across several years allows analysts to identify any potential discrepancies in reporting from one year to the next. Examining the sales performance of a company against that of its competitors in the industry allows analysts to check if identified anomalies are industry wide or company specific. The following section contains sales

manipulation diagnostics for J. C. Penny, Kohl's, Dillard's, Stage Stores, Inc., and Stein Mart, Inc.

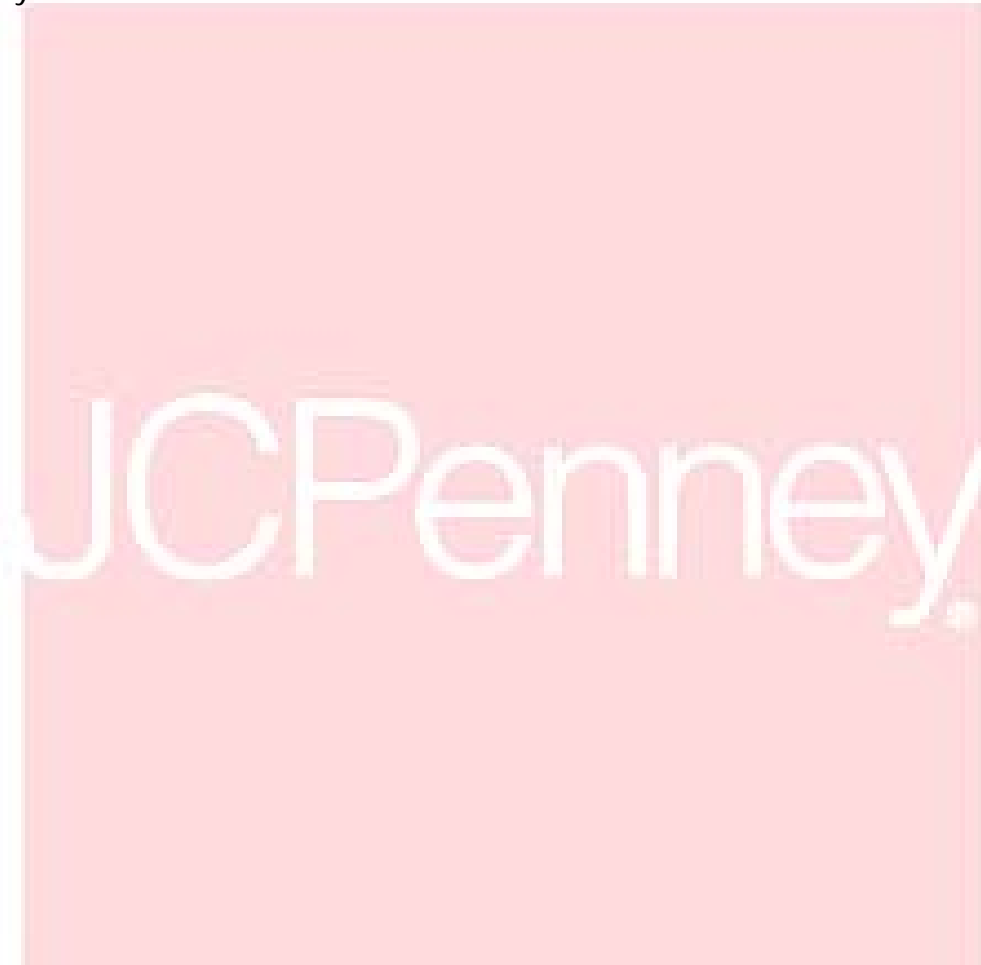
Net Sales/Cash From Sales



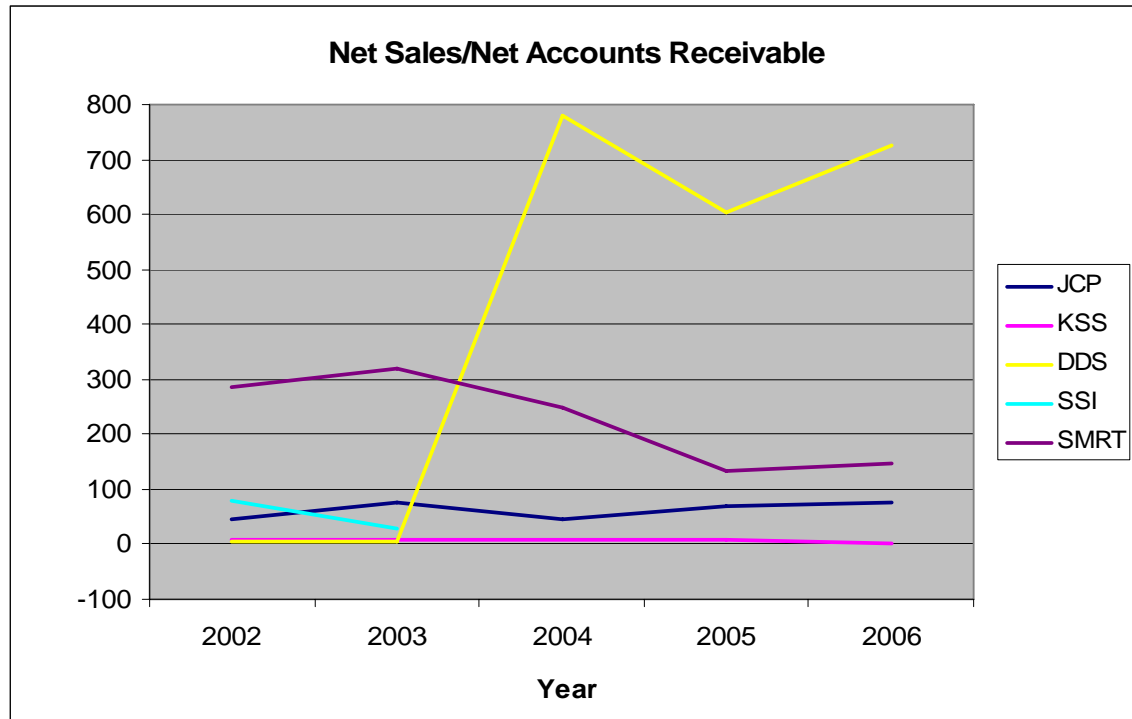
The ratio of net sales to cash from sales compares sales minus returns to the amount of cash actually received from those transactions each year. A 1:1 ratio is ideal; however, in most cases, impractical. A large percentage of consumers use credit cards to make purchases. If a customer uses a major credit card like Master Card, Visa, or Discover, revenues can be booked as cash almost immediately, since the liability of default falls on the creditor's shoulders and not the retailer's. However, if using a private label credit card, the revenue must be booked as a receivable and payment must be collected before it can be recognized as cash.

Most companies in the department and discount segment of the retail industry do not have private label credit cards due to the high risk of default. Typically, firms will pay a small fee to have a major credit card company accept that risk for them. Among the firms evaluated here, J. C. Penney is the only

company still using a private label credit card. In 2004, J. C. Penney experienced an increase in the use of its private label credit card, which explains the sudden deviation from the industry norm. Dillard's had a private label credit up until 2004, when it sold its credit card company to GE Finance Company (Dillard's 2007 10K), explaining the rapid increase in its ratio of net sales to cash from sales from 0.8:1 to 1:1. Overall, this specific ratio is supported by the J. C. Penney financial statements.



Net Sales/Net Accounts Receivable

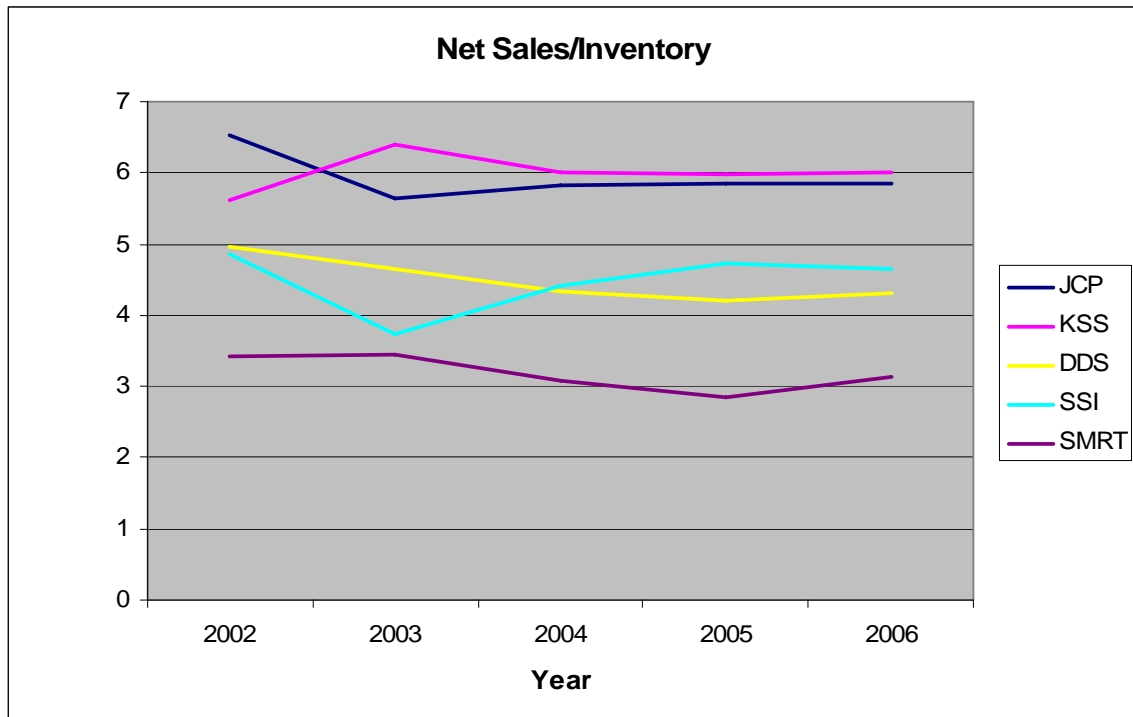


When examining net sales in relation to accounts receivable, you can see that the industry, with the exception of Dillard's and Stein Mart, maintains a fairly low ratio. J. C. Penney did not show in drastic rises in this ratio, indicated that over the last five years, sales have been supported by account receivables on a consistent basis. This shows fairly stable. Other players in the industry have almost zero accounts receivable because they have no company credit card operations whereas J. C. Penney does. In 2004, J. C. Penney's net sales/accounts receivable ratio dipped due to the sale of Eckerd Pharmacy, then rose due to higher sales in 2005.

Other companies in the department and discount segment of the retail industry seem to maintain relatively acceptable amounts of accounts receivable, with the exception of Dillard's and Kohl's, where accounts receivable accounted for up to 17 and 13 percent of their net sales, respectively. In an effort to correct this problem, Dillard's sold its private label credit card company to GE Finance Company in 2004, and Kohl's factored its accounts receivable and sold them to JP Morgan Chase in 2005 (Kohl's 2007 10K). This reduced Kohl's

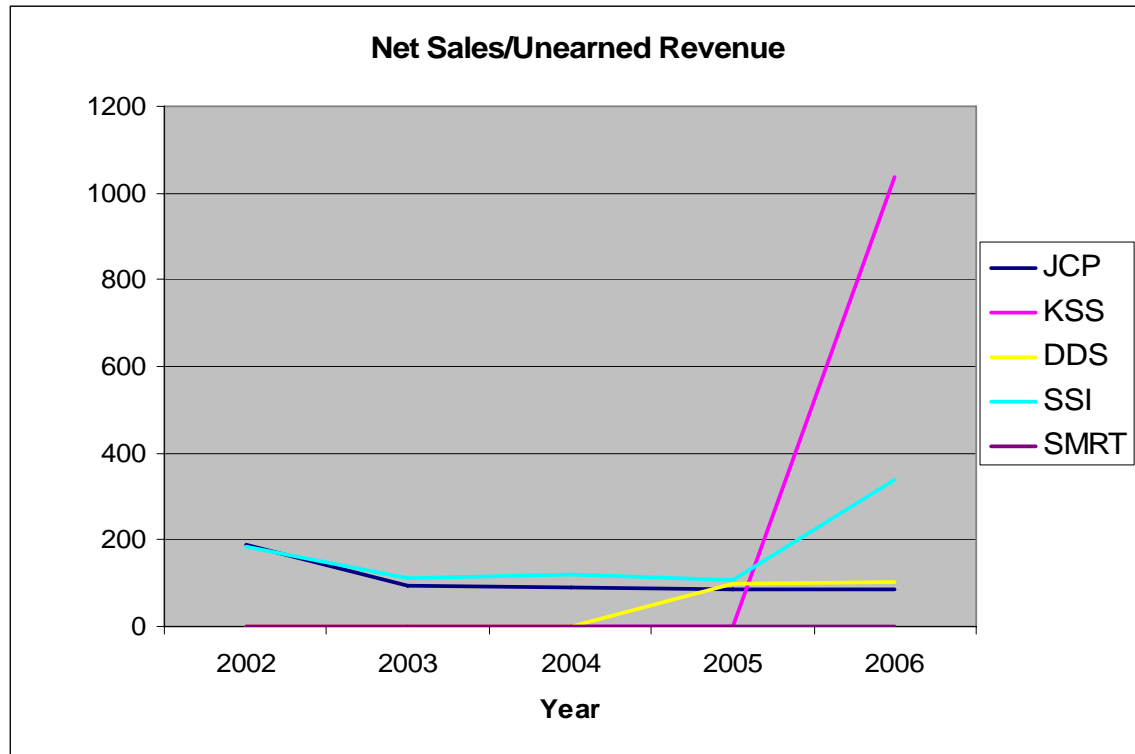
accounts receivable to zero resulting in a ratio that no longer applies to the company.

Net Sales/Inventory



Over the last five years, all five companies looked at in this industry have maintained a relatively steady inventory turnover. Even in the event of the sales of businesses in the last three years, J. C. Penney had preserved a steady ratio. In essence, this ratio evaluates how well a firm uses its inventory to generate revenue. Because it has not spiked unexpectedly, there are no indicators that sales have been overstated in respect to inventory.

Net Sales/Unearned Revenue

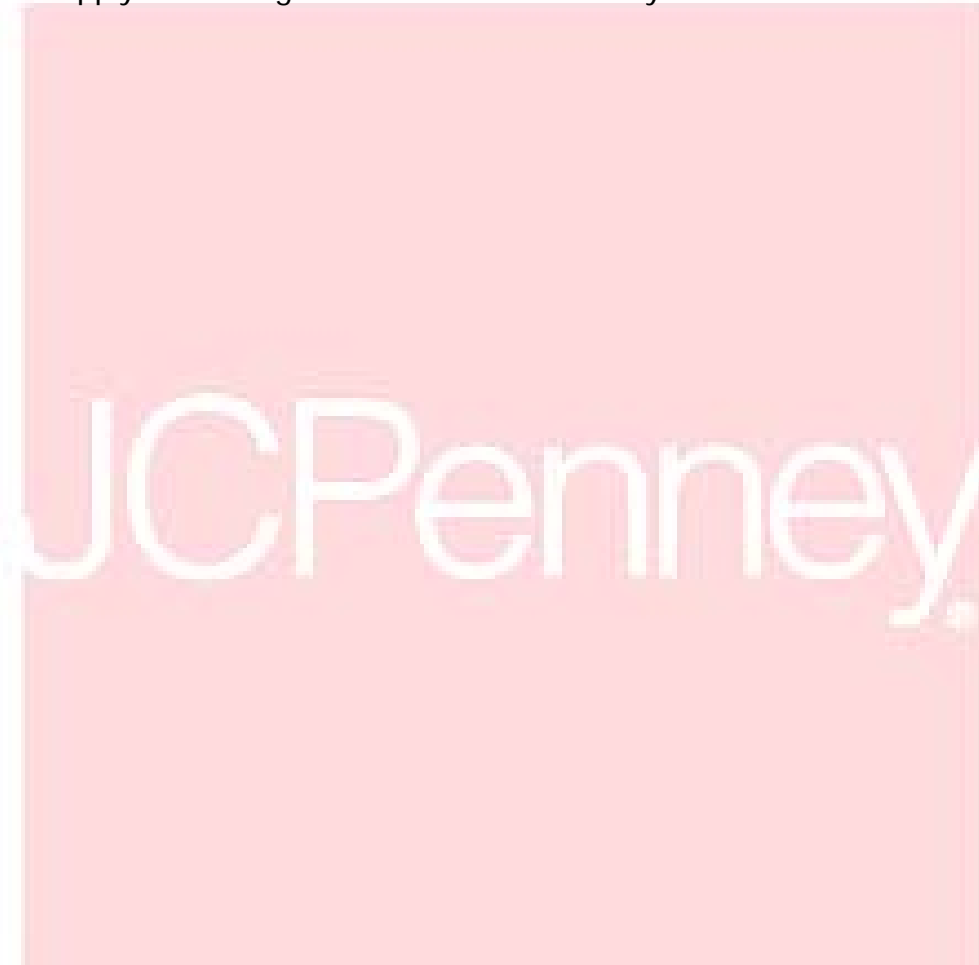


When evaluating the ratio of net sales to unearned revenue, analysts look for unexplained changes in the level of unearned revenue. For instance, if the ratio of net sales to unearned revenue increases dramatically, the firm may be recognizing revenue before it is actually earned in an effort to improve earnings. Firms sometimes do this in order to improve sales numbers, when actual sales come in below estimates. This sort of manipulation is cause for concern and is a potential “red flag” indicating fraudulent behavior.

Looking at this graph, we see a great deal of variation in the ratio between firms. Some of this activity is explainable. For instance, Dillard’s and Kohl’s sudden rise in unearned revenue was most likely caused by a change in disclosure. In previous years, Dillard’s and Kohl’s did a poor job of separating its unearned revenues from its other liabilities. In 2004 and 2006, respectively, Dillard’s and Kohl’s disaggregated their liabilities to reveal unearned revenue liabilities from gift cards, which is a common practice among companies in the retail industry.

Net Sales/Warranty Liabilities

None of the companies examined in this report offer warranties or extended warranties on any of their products or services. All warranties associated with products and services sold through these retailers are manufacture warranties. The firms in this report have no warranty liabilities compare against net sales; therefore, the ratio of net sales to warranty liabilities does not apply to this segment of the retail industry.



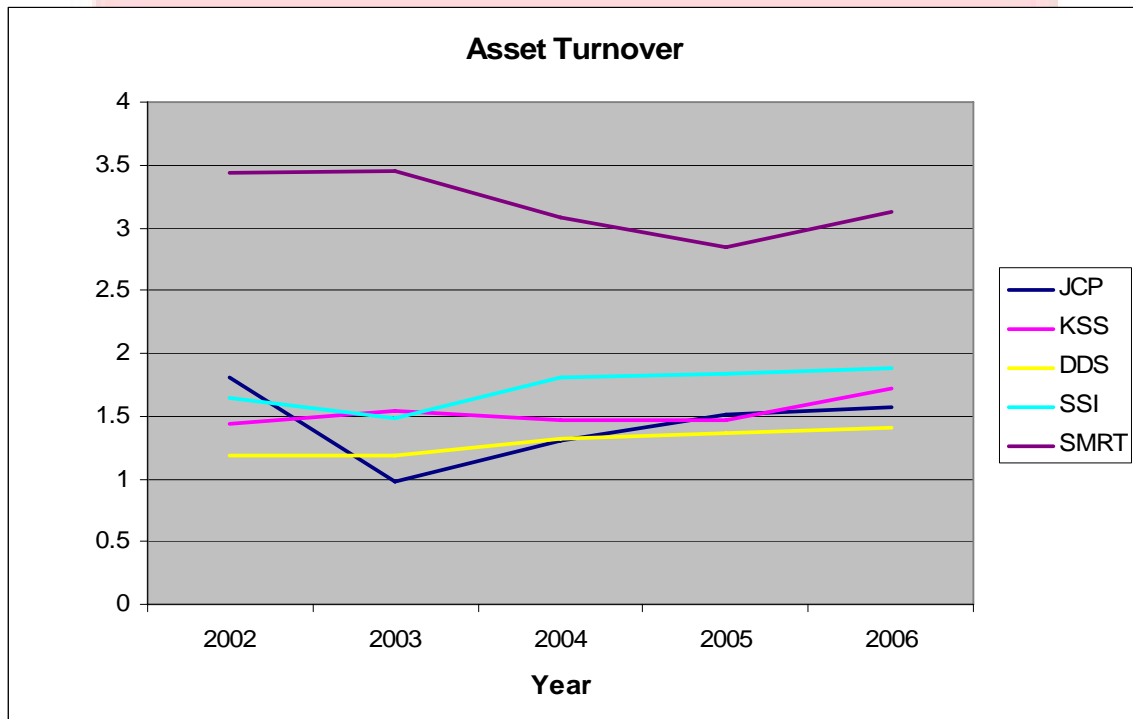
Below is a chart of sales manipulation diagnostics used to create previous graphs of J.C. Penney and industry competitors.

Sales Manipulation Diagnostics					
	2002	2003	2004	2005	2006
JCP					
Net Sales/Cash From Sales	0.9944	1.0249	0.8153	0.9185	0.9996
Net Sales/Net Account Receivables	45.882	76.334	45.603	69.559	75.676
Net Sales/Inventory	6.5413	5.6356	5.8138	5.8507	5.8538
Net Sales/Unearned Revenues	186.97	92.155	89.004	85.757	86.160
Net Sales/Warranty Liabilities	n/a	n/a	n/a	n/a	n/a
KKS					
Net Sales/Cash From Sales	1.0270	0.9935	1.0185	1.0135	1.0263
Net Sales/Net Account Receivables	9.2048	8.9397	8.4199	8.1124	n/a
Net Sales/Inventory	5.6055	6.3983	6.0096	5.9896	6.0060
Net Sales/Unearned Revenues	n/a	n/a	n/a	n/a	1036.2
Net Sales/Warranty Liabilities	n/a	n/a	n/a	n/a	n/a
DDS					
Net Sales/Cash From Sales	1.0344	0.9810	0.8643	1.0003	0.9997
Net Sales/Net Account Receivables	5.9121	6.3776	780.08	603.70	726.68
Net Sales/Inventory	4.9620	4.6551	4.3441	4.1938	4.3089
Net Sales/Unearned Revenues	n/a	n/a	n/a	100.40	101.95
Net Sales/Warranty Liabilities	n/a	n/a	n/a	n/a	n/a
SSI					
Net Sales/Cash From Sales	0.9994	1.0254	0.9725	1.0000	1.0000
Net Sales/Net Account Receivables	79.430	27.688	n/a	n/a	n/a
Net Sales/Inventory	4.8663	3.7437	4.4172	4.7383	4.6585
Net Sales/Unearned Revenues	182.40	110.47	12.076	107.52	336.99
Net Sales/Warranty Liabilities	n/a	n/a	n/a	n/a	n/a
SMRT					
Net Sales/Cash From Sales	1.0108	1.0068	1.0072	1.0066	1.0068
Net Sales/Net Account Receivables	286.36	320.66	249.42	133.22	147.70
Net Sales/Inventory	3.4339	3.4487	3.0755	2.8501	3.1254
Net Sales/Unearned Revenues	n/a	n/a	n/a	n/a	n/a
Net Sales/Warranty Liabilities	n/a	n/a	n/a	n/a	n/a

Expense Manipulation Diagnostics

Examining the sales performance of a company across several years allows analysts to identify any potential discrepancy in reporting from one year to the next. Examining the sales performance of a company against that of its competitors in the industry allows analysts to check if identified anomalies are industry wide or company specific. The following section contains expense manipulation diagnostics for J. C. Penney, Kohl's, Dillard's, Stage Stores, Inc., and Stein Mart, Inc.

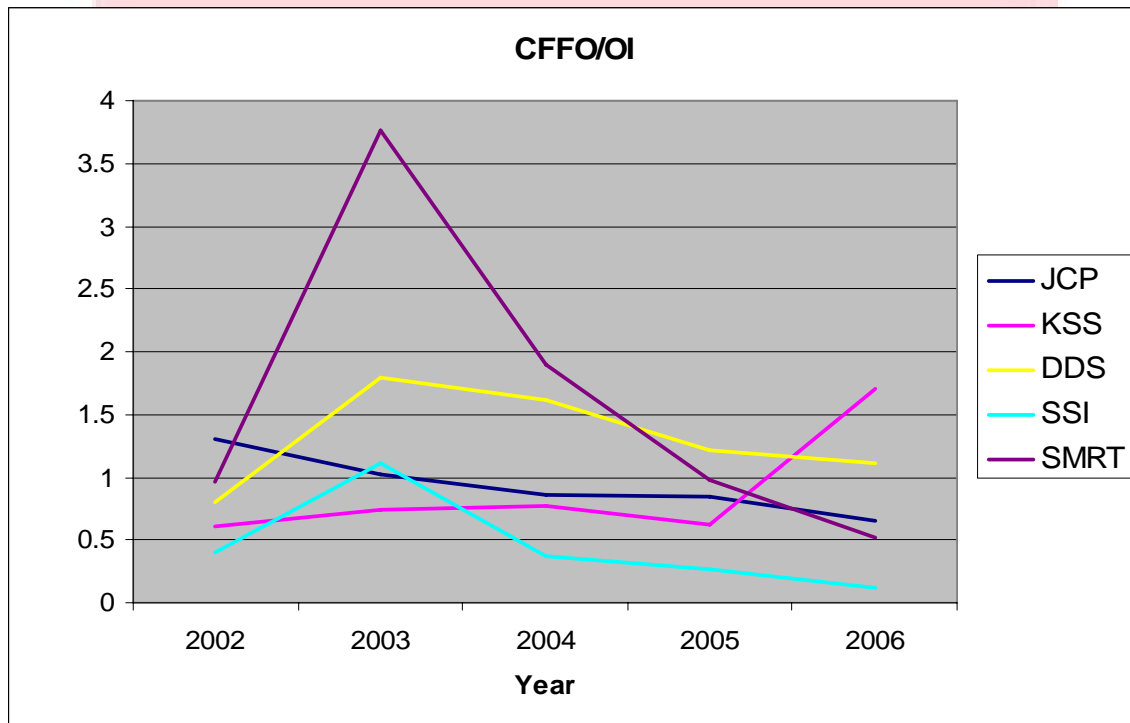
Asset Turnover



Asset turnover for J. C. Penney has also maintained steady of the last five years. An increase in this ratio would show a red flag indicating assets were overstated. As you can see, the ratio slightly increases overtime. This is not due to a great change in assets but an increase in sales 2004 and on after the sale of unprofitable businesses.

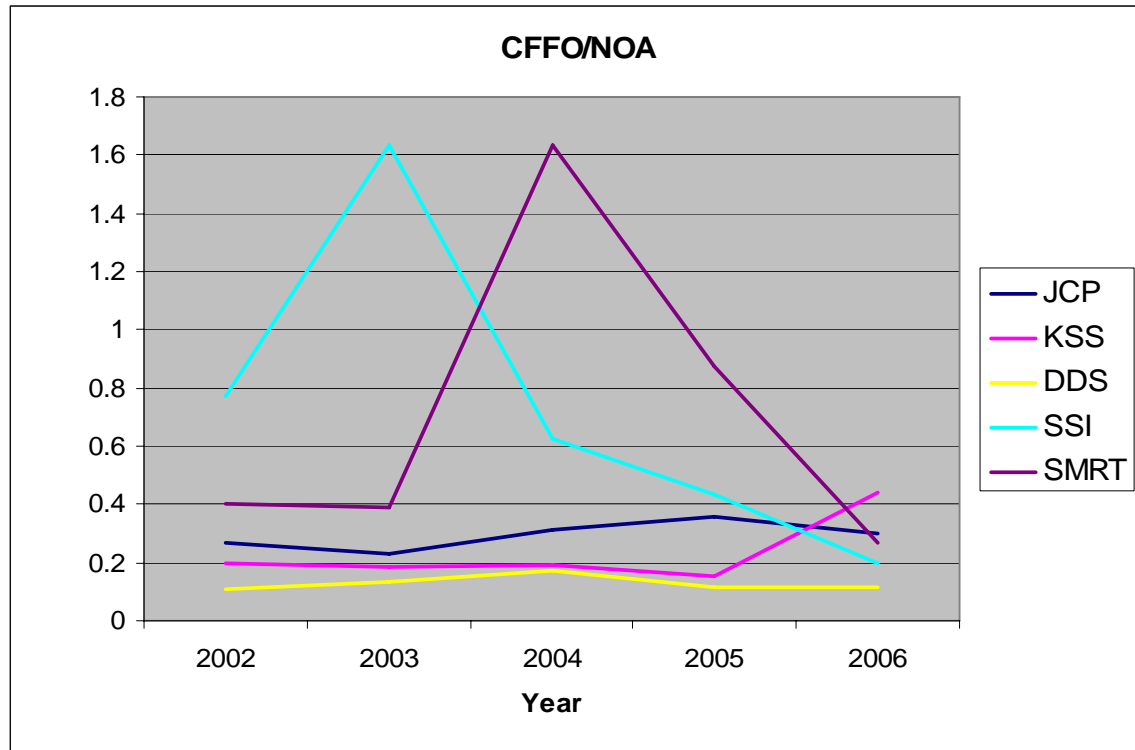
As for the industry, all the companies examined in this report have about the same asset turnover ratio with one obvious exception, Stein Mart, Inc. Stein Mart, Inc. achieves a significantly higher asset turnover ratio because it uses a variation of the just-in-time inventory method in order to keep on hand inventory as low as possible.

Cash Flows From Operating Activities/Operating Income



The cash flows from operating activities to operating income ratio links the amount of cash generated by operating activities to the amount of operating income reported on the income statement. A lower ratio is preferred because it shows that more cash is generated by operating activities rather than investing or financing activities. Over the past few years, there has been a downward trend in this ratio in the retail industry. In other words, firms in the department and discount segment of the retail industry are creating more income through operating activities.

Cash Flows From Operating Activities/Net Operating Assets



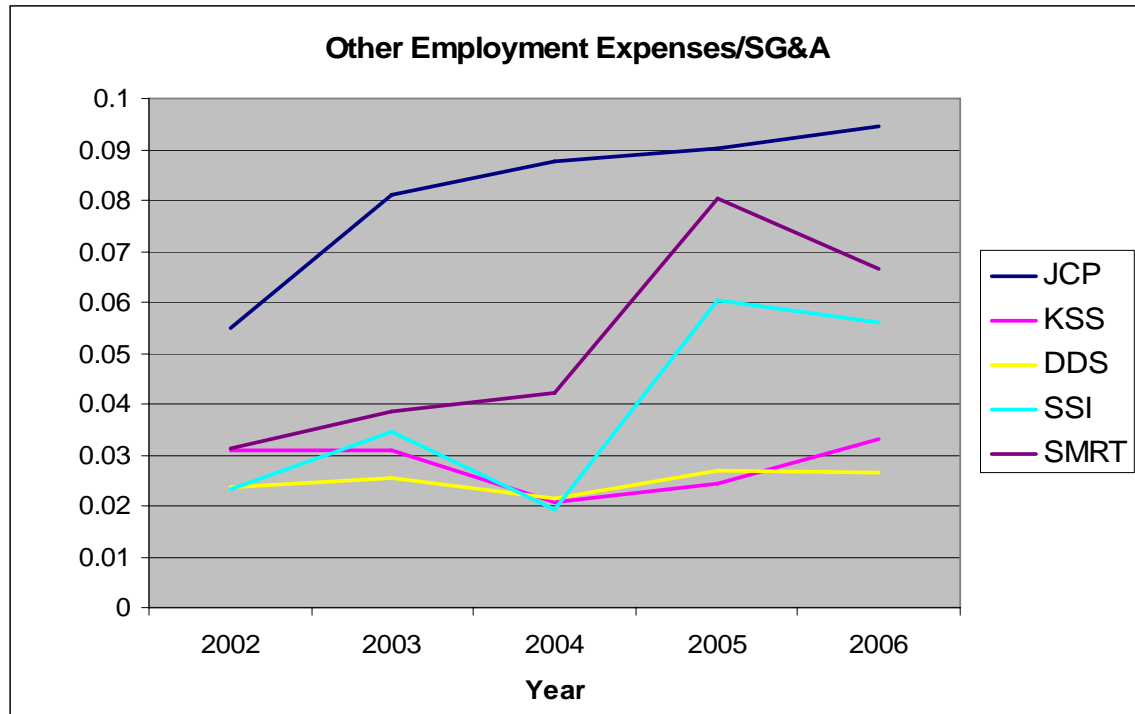
The ratio of cash flows from operating activities to net operating assets links the cash flows from operating activities to a firm's fixed assets, property, plant, and equipment. The higher the ratio the more income generated by those fixed assets. Most companies in the department and discount segment of the retail industry have low ratios of CFFO/NOA due the practice of expensing large fixed assets like property and buildings instead of capitalizing them. Although, this is a questionable accounting practice, it is perfectly legal and widely used by firms in this industry.

Pension Expense/SG&A



The pension expense to selling, general, and administrative expense ratio shows the relationship between pension expense and operating expenses. Effectively, this ratio is used to determine if a company is spending too much money on its retirees. A lower ratio is preferred because it shows that pension expense makes up an insignificant amount of the companies overall expenses. Pension and retirement expenses expend resources that could be put to better use within the company. In other words, a firm should not be spending a great deal of money on people who are no longer employed by the company. Overall, all firms in the department and discount segment of the retail industry maintain a low pension expense to selling, general, and administrative expense ratio.

Other Employment Expenses/SG&A



The ratio of other employment expenses to selling, general, and administrative expenses represents the amount spent on employee benefits (other than pension expenses) compared to other operating expenses. These benefits typically include medical insurance, dental insurance, and life insurance, as well as supplemental retirement programs. These expenses are relatively insignificant in comparison to other operating expenses paid by the firms in this industry. Nonetheless, with the increasing cost of insurance and the growing number of retirees, these expenses are steadily increasing for every company in this industry. Therefore, a decrease in this ratio may reveal potential accounting abuses on the part of the firm.

Below is a chart of all expense manipulation diagnostics used to create the above graphs comparing J. C. Penney to industry competitors.

Expense Manipulation Diagnostics					
	2002	2003	2004	2005	2006
JCP					
CFFO/OI	1.3106	1.0278	0.8589	0.8478	0.6529
CFFO/NOA	0.2711	0.2310	0.3097	0.3567	0.3015
Asset Turnover	1.8104	0.9719	1.3041	1.5071	1.5705
Total Accruals/Change in Sales	90.431	-1.1657	27.111	48.862	16.620
Pension Expense/SG&A	0.0027	0.0222	0.0140	0.0118	0.0016
Other Employment Expenses/SG&A	0.0549	0.0809	0.0876	0.0900	0.0945
KKS					
CFFO/OI	0.6140	0.7372	0.7662	0.6225	1.7078
CFFO/NOA	0.1995	0.1840	0.1905	0.1523	0.4423
Asset Turnover	1.4441	1.5349	1.4663	1.4642	1.7192
Total Accruals/Change in Sales	0.3160	0.4357	0.3786	0.5335	-0.517
Pension Expense/SG&A	n/a	n/a	n/a	n/a	n/a
Other Employment Expenses/SG&A	0.0309	0.0309	0.0206	0.0244	0.0330
DDS					
CFFO/OI	0.7998	1.7945	1.6152	1.2179	1.1092
CFFO/NOA	0.1059	0.1351	0.1741	0.1168	0.1141
Asset Turnover	1.1850	1.1852	1.3227	1.3703	1.4119
Total Accruals/Change in Sales	-30.970	-22.966	-99.123	227.42	95.900
Pension Expense/SG&A	0.6183	0.5679	0.0045	0.0061	0.0050
Other Employment Expenses/SG&A	0.0236	0.0255	0.0212	0.0269	0.0265
SSI					
CFFO/OI	0.3963	1.1171	0.3682	0.2708	0.1216
CFFO/NOA	0.7738	1.6358	0.6239	0.4342	0.1978
Asset Turnover	1.6434	1.4747	1.8105	1.8370	1.8790
Total Accruals/Change in Sales	-0.1053	-2.6626	-0.2982	-0.4999	0.0006
Pension Expense/SG&A	0.0012	0.0016	0.0002	0.0002	0.0006
Other Employment Expenses/SG&A	0.0232	0.0345	0.0192	0.0603	0.0561
SMRT					
CFFO/OI	0.9650	3.7645	1.8966	0.9717	0.5234
CFFO/NOA	0.4020	0.3882	1.6324	0.8766	0.2677
Asset Turnover	3.4339	3.4487	3.0755	2.8501	3.1254
Total Accruals/Change in Sales	-0.1585	0.5201	-0.7489	-1.1577	0.3484
Pension Expense/SG&A	0.0049	0.0030	0.0028	0.0023	0.0036
Other Employment Expenses/SG&A	0.0313	0.0384	0.0420	0.0804	0.0664

Conclusion

Some firms within the department and discount segment of the retail industry demonstrate some questionable accounting practices when compared to their peers within the industry. However, such inconsistencies may be explained by changes in accounting policies or unusually good (bad) sales activity. Nonetheless, any inconsistency needs to be thoroughly investigated for accounting abuse.

Of the firms evaluated by these sales and expense manipulation diagnostics, J. C. Penney appears to be the most consistent in its accounting and reporting practices. Although nothing unusual seems to be jumping off the page, assuming J. C. Penney's financial statements are complete and correct is foolish. Analysts, regulators, and investors, alike, must have a healthy amount of skepticism when using the financial statements of this firm, or any firm, to make financial decisions.

Potential "Red Flags"

Accounting distortions can be found by examining the financial statements and the information held there within using ratio analysis over a period of comparative years. In the case of this accounting analysis, we have looked over five years of data. The discrepancies found during this analysis are viewed as red flags. These red flags could be accounting errors; however, they may be an indication of accounting manipulation and abuse.

Potential red flags, in regards to the J.C. Penney Company, are limited. Even with careful analysis, we were unable to find any significant discrepancies in reporting. In fact, the annual 10-K reports filed with the SEC have improved, making reporting and disclosures more transparent. Of all the firms we have researched, which include the following: Stage Stores, Stein Mart, Kohl's, and Dillard, the J. C. Penney Company has the highest level of disclosure and the most revealing financial statements. For example, J. C. Penney's discloses

discount rates in respect to pensions. Not only does the company show these rates, but they also go into detail on pension contributions and benefits in the manager's discussion and analysis section, as well as lengthy explanations in the appendices.

Another example of the company's high level of disclosure is the operating and capital leases. J.C. Penney does an excellent job of disclosing the remaining obligations of both types of leases. They are straightforward with the discount rates of these leases, which takes the guesswork out of estimating. The following shows the interest rates found within the most recent J. C. Penney 10-K annual report.

Capital Leases	6.0 %
Operating Leases	7.9 %

Because this information is disclosed, backing into an interest rate for future forecasts of the J. C. Penny is not required. The company also provides the present value of all future lease payments for the next 20 years, according to the 2006 10-K. Not only does this show that the company has no significant distortions, it also shows the breadth and depth of the financial statements.

While analyzing the sales and expense ratios, one can agree that the J. C. Penney Company is the most consistent in its accounting and reporting practices. There were no relevant or significant errors in the ratio analysis to lead us to believe there were any problems. It should be noted, however, analysts must maintain a slight amount of skepticism when valuing the firm using company financial statements.

Coming Undone (Undo Accounting Distortions)

After careful consideration and extensive research, we as a group have

concluded that there are no accounting distortions that need to be “undone.” Once again, J.C. Penney is a very transparent business when compared to all of the retail competitors in this specific industry. Re-estimation of lease agreements was not necessary because all needed information was provided within the footnotes and discussions relating to the financial statements. When we compare the interest payments of all capital leases to the sum of all operating lease payments, you can see the insignificance of operating leases.

	Total	2007	2008	2009	2010	2011	After 5 yrs
Interest pmts on LTD and capital Leases	\$5822	\$253	\$222	\$218	\$198	\$178	\$4753
Operating Leases	\$1948	\$213	\$197	\$170	\$137	\$112	\$1119

Above, the chart shows exactly this, that the operating leases that are on the financials are peanuts compared to the sales of J.C. Penney.

Financial Analysis, Forecast Financials, and Cost of Capital Estimation

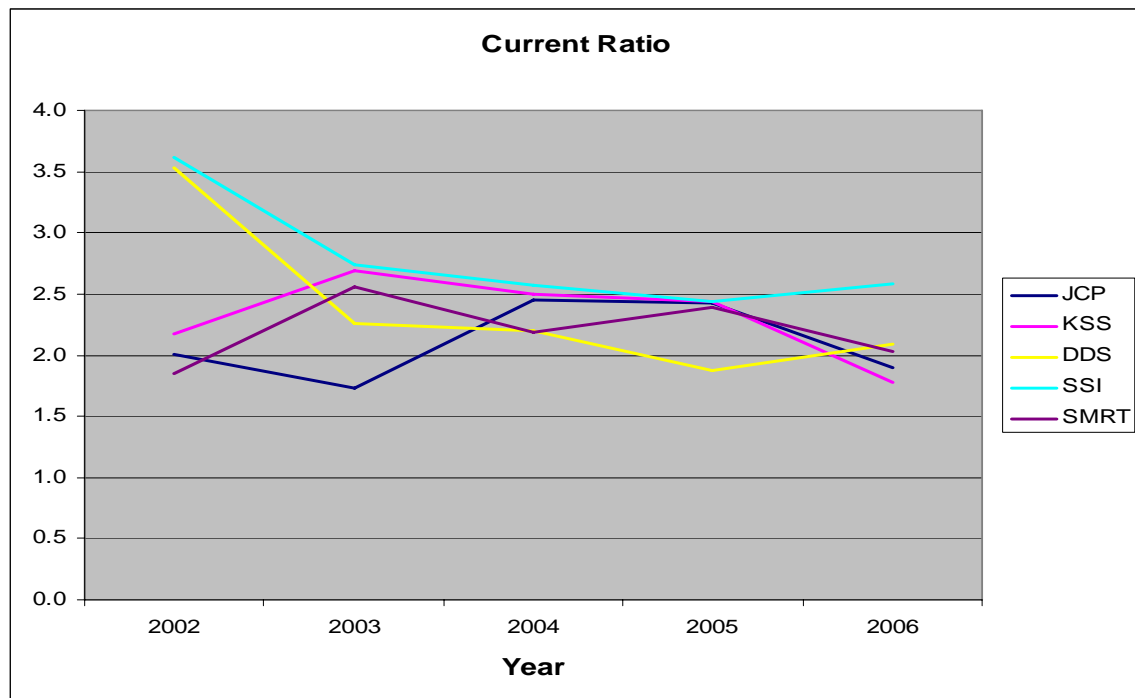
Financial Analysis

In an effort to accurately evaluate the overall financial health and profitability of a firm, analysts have developed a series of ratios to breakdown a firm's financial statements into numbers that can be easily compared to those of its competitors within its industry. The ratios most commonly used when evaluating a company's overall financial health and profitability are divided into three categories: liquidity, profitability, and capital structure. By comparing the ratios of companies within the same industry, analysts can draw conclusions about the performance of a single firm in relation to its competitors. Simply put, this section of the report will help determine how well J. C. Penney stacks up to the competition.

Liquidity Analysis

Liquidity ratios are used to provide information about a firm's ability to meet its short-term financial obligations (www.netmba.com). Liquidity ratios help lenders evaluate the credit risk associated with prospective borrowers. Lenders generally prefer higher liquidity ratios because it demonstrates that a firm has adequate resources to pay off its short-term financial obligations should the need arise. Common liquidity ratios include the current ratio, quick ratio, inventory turnover, receivables turnover, and working capital turnover. The following section exams these ratios.

Current Ratio

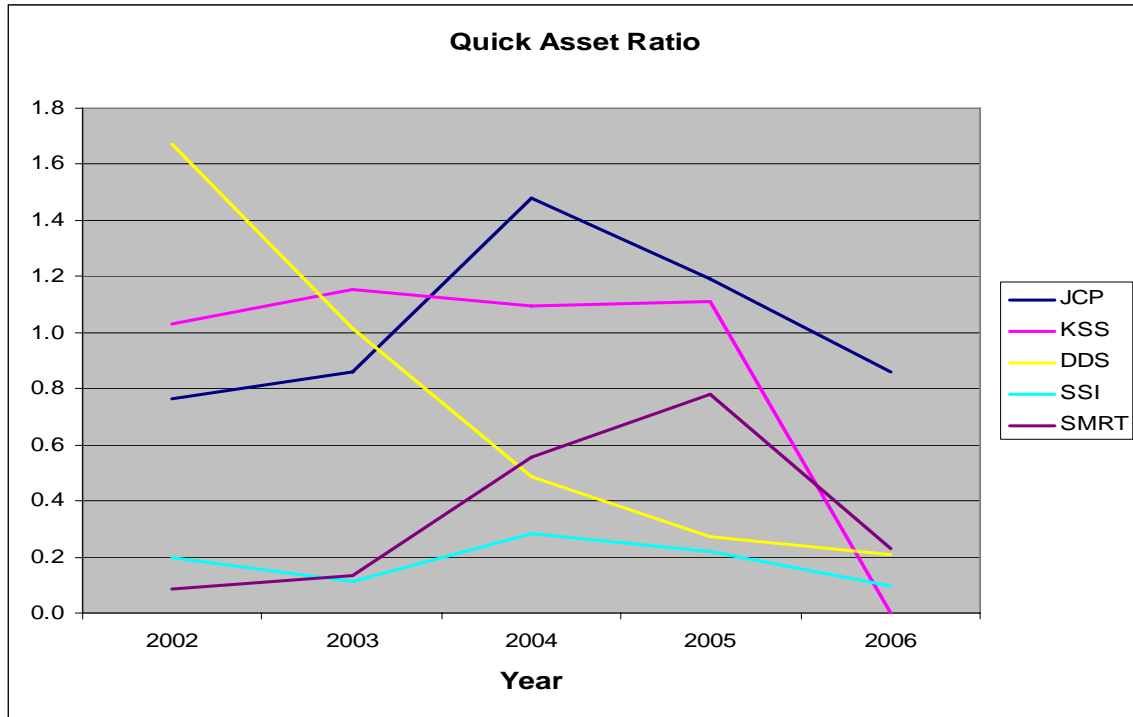


The current ratio is the relationship between a company's current assets (cash, cash equivalents, short-term investments, receivables, and inventory) and the current or short-term liabilities (short-term debt and payables). The main function of this ratio is to determine a company's ability to pay back its short-term liabilities in a hurry, should the need arise. The higher the ratio the more likely a company will be able to pay off its obligations. For instance, a company with a ratio of 1:1 has \$1 of current assets for every \$1 of short-term liabilities, which means should there be able to pay off short-term liabilities immediately; however, this just covers the basic need. A better turnover would be involve more assets or less liabilities.

J. C. Penney typically maintains a current ratio of 2:1, which means that J. C. Penney is unlikely to default on any of its short-term liabilities. Furthermore, as you can see from the graph, some retailers have held current ratios as high as 3.5:1, but most companies within this segment have converged on 2:1. This means that companies in this segment of the retail industry are capable of

paying off their short-term obligations with a fair degree of certainty. Overall, J. C. Penney is inline with the industry standard.

Quick Ratio

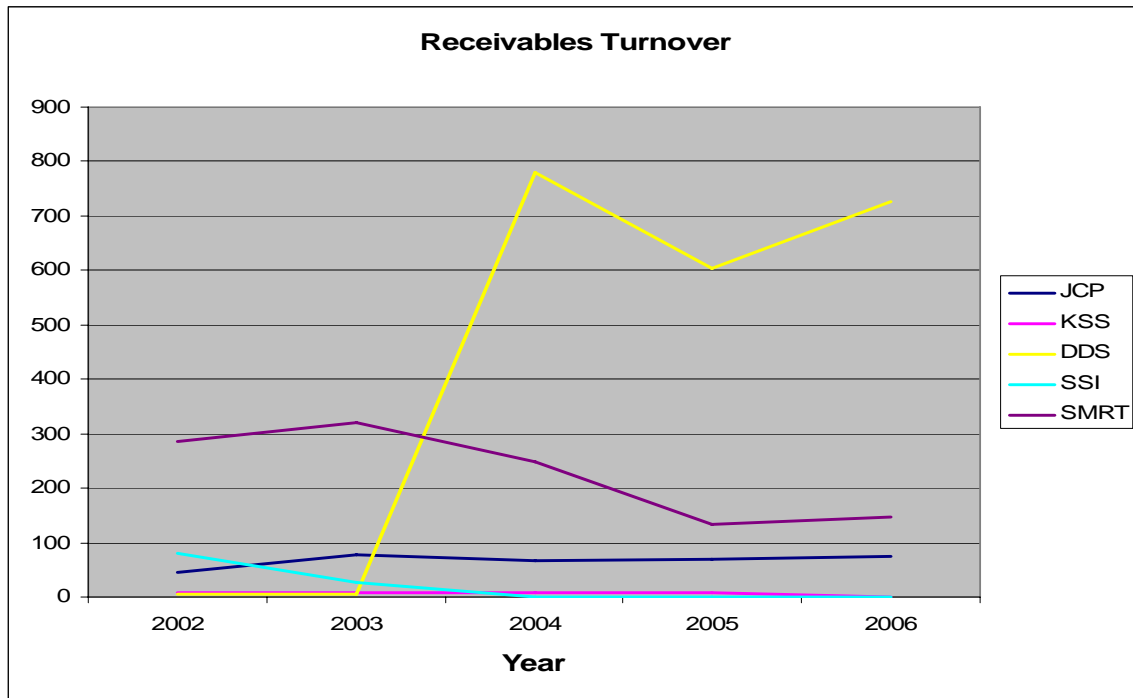


The quick ratio, otherwise known as the acid-test ratio, is the relationship between a company's current assets minus inventory (cash, cash equivalents, short-term investments, and receivables) and its current liabilities. The quick ratio is far more conservative than the current ratio because it excludes inventory. This is because inventory can be difficult for a company to convert into cash. Therefore, the quick ratio provides a clearer picture of a company's financial strength in the event it must pay off its short-term liabilities than the fore mentioned current ratio.

J. C. Penney seems to keep a quick ratio of 0.8:1, meaning the company only has \$0.80 of liquid assets per \$1 of short-term liabilities. Should J. C. Penney have to pay off its short-term liabilities immediately, it may come across a serious hurdle of liquidity. Although this is not the ideal situation for any company and may be reason for concern, it is common in the retail industry,

where the largest portion of a company's current assets is inventory. Although the overall industry is converging, J. C. Penney still maintains one of the highest quick ratios.

Receivables Turnover

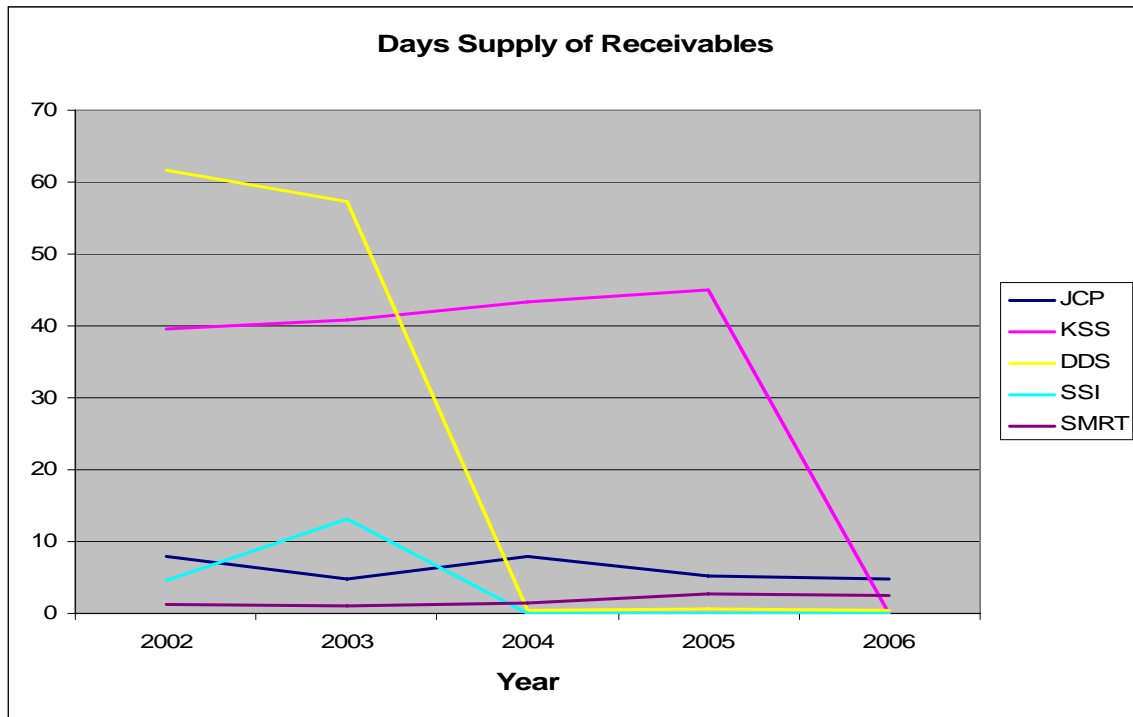


The receivables turnover ratio is the relationship between a company's net sales and its accounts receivable. The receivables turnover ratio is used to evaluate how efficiently a firm uses its assets. A high ratio is preferred because it suggests that a company operates primarily on a cash basis or that it efficiently collects on its accounts receivable. For instance, if a company has a receivables turnover ratio of 50:1, then the company generates \$50 of revenue for every \$1 of credit it extends.

Historically, J. C. Penney has maintained a receivables turnover ratio of between 45 and 75; however, over the past four years this ratio has risen steadily because of the company's continuous earnings growth and the steady retirement of its accounts receivable. This ratio is unusually high for J. C. Penney, Stein Mart, and Dillard's and not applicable to Kohl's and Stage Stores

because many firms in this segment of the retail industry no longer finance their private label credit cards. Today, companies like GE Finance Corporation provide retailers with consumer finance services for a fee, which enable retailers to book sales immediately.

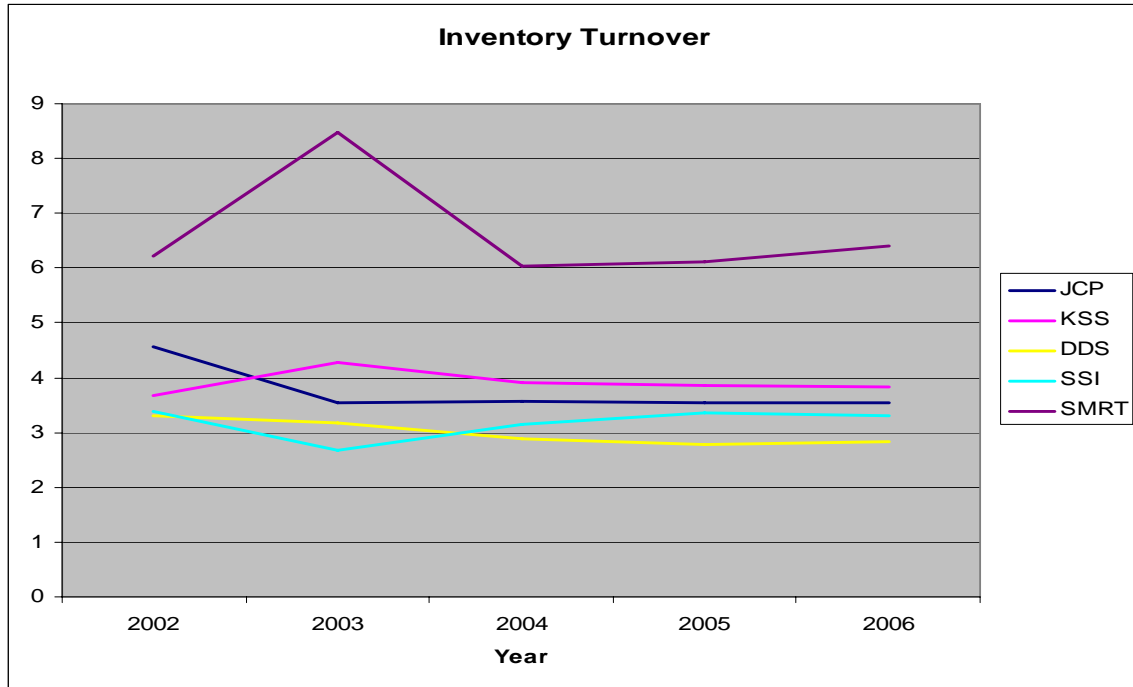
Days Sales Outstanding



Days sales outstanding is a measure of how long it takes for a company to collect on its accounts receivables. This is also the second half of the cash-to-cash cycle. The first half, days supply of inventory, is discussed later. In most industries, this process varies from 30 days to 90 days, but in the department and discount segment of the retail industry this number is typically low. For instance, J. C. Penney's days sales outstanding over the past five years has averaged around six days. This is possible because J. C. Penney, like most retailers in this industry, does not finance its own private label credit card. Instead, J. C. Penney pays a fee to a company, like GE Finance Corporation, to handle consumer credit cards. In essence, the private label credit card acts like

a MasterCard or VISA, allowing J. C. Penney to recognize revenues immediately and keeps its accounts receivable minimized.

Inventory Turnover

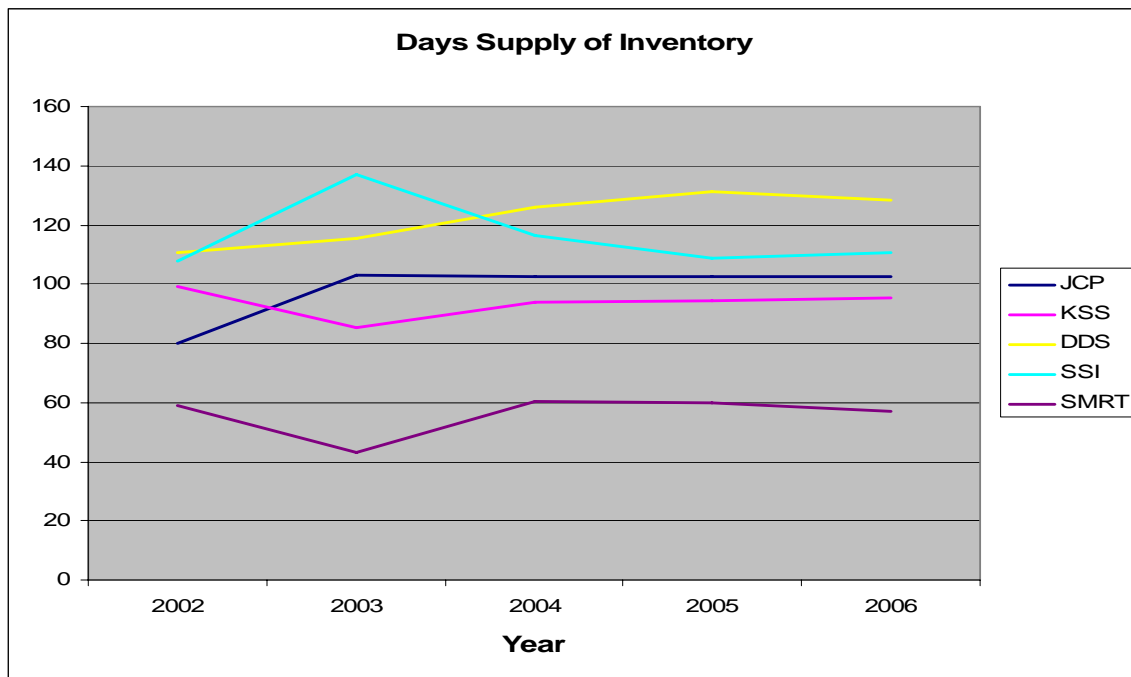


Inventory turnover is the ratio between cost of goods sold and its inventory. Inventory turnover measures how many times a company sells and replaces its inventory throughout the year. A low ratio suggests poor sales and excess inventory. A high ratio implies strong sales or possibly insufficient inventory levels. Because inventory ties up money that could be used for other investment, it is important for a firm to maintain a steady turnover of its inventory.

J. C. Penney has averaged a ratio of 3.5:1 over the past five years. In other words, the company turns its inventory almost four times a year, or approximately once every 3 ½ months. This means that cash is tied up in inventory for almost 3 ½ months. Although this seems like a long time, it is very common in the department and discount store segment of the retail industry due to the seasonality of the product lines sold in these stores. In other words, J. C.

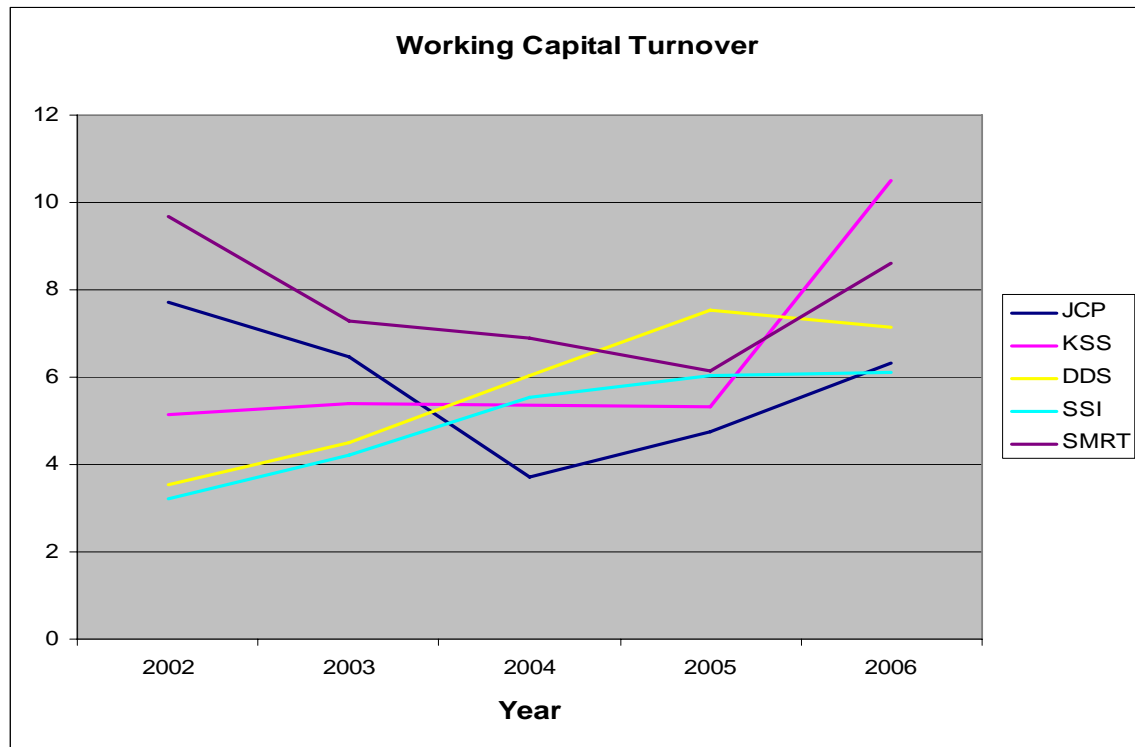
Penney's inventory turnover is in line with the industry standard. Where as Stein Mart outperforms the industry because it uses a variation of the just-in-time inventory method to keep inventory low.

Days Supply of Inventory



Days supply of inventory is a measure of how long inventory sits idle. Days supply of inventory is the first half of the cash-to-cash cycle. In the case of most firms in the department and discount segment of the retail industry, inventory turns over approximately once every 90 to 120 days (once every 3 to 4 months). For instance, J. C. Penney turns its inventory every 103 days (3 ½ months). When you combine days supply of inventory with days sales outstanding, you get the cash-to-cash cycle. In the case of J. C. Penney, the cash-to-cash cycle takes approximately 109 days. This is quite common among these firms due to the nature of the retail industry. The retail industry is prone to affects of seasonality. Stores like J. C. Penney typically liquidate and replenish their inventory with every season.

Working Capital Turnover



The working capital turnover ratio is used to analyze the relationship between the money used to fund operations and the sales generated from these operations (www.investopedia.com). In a general sense, a higher working capital turnover is better because it means that the company is generating greater sales as compared to the money it uses to fund the sales. For instance, a company with sales of \$10 million and working capital of \$1 million has a working capital turnover for the year of 10. Therefore, for every \$1 of working capital the company has it generates \$10 of sales.

Over the past five years, J. C. Penney has averaged a working capital turnover of approximately 5.8, meaning it is generating \$5.80 of sales for every \$1 of working capital. This is on the lower half of the spectrum for the industry average.

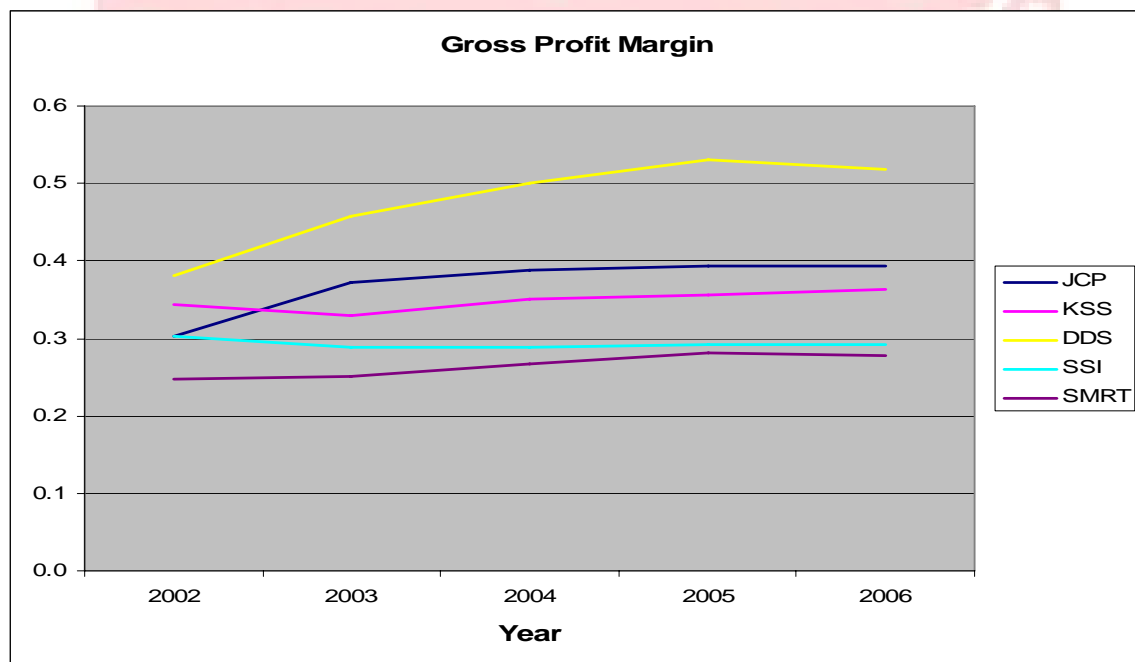
Conclusion

Analysis through liquidity ratios shows that J. C. Penney is a liquid firm. J. C. Penney's current ratio, inventory turnover, receivables turnover, and working capital turnover are all in line with the department and discount segment of the retail industry. J. C. Penney slightly outperforms its peers in the quick ratio, meaning it is potentially the most liquid firm evaluated in this report.

Profitability Analysis

The main objective of profitability analysis is to determine how efficiently a firm can turn a profit. Profitability analysis is comprised of six ratios: gross profit margin, operating expense ratio, net profit margin, asset turnover, return on assets, and return on equity. The first three ratios measure a firm's operating efficiency, and the next three ratios measure asset productivity, return on assets, and return on equity.

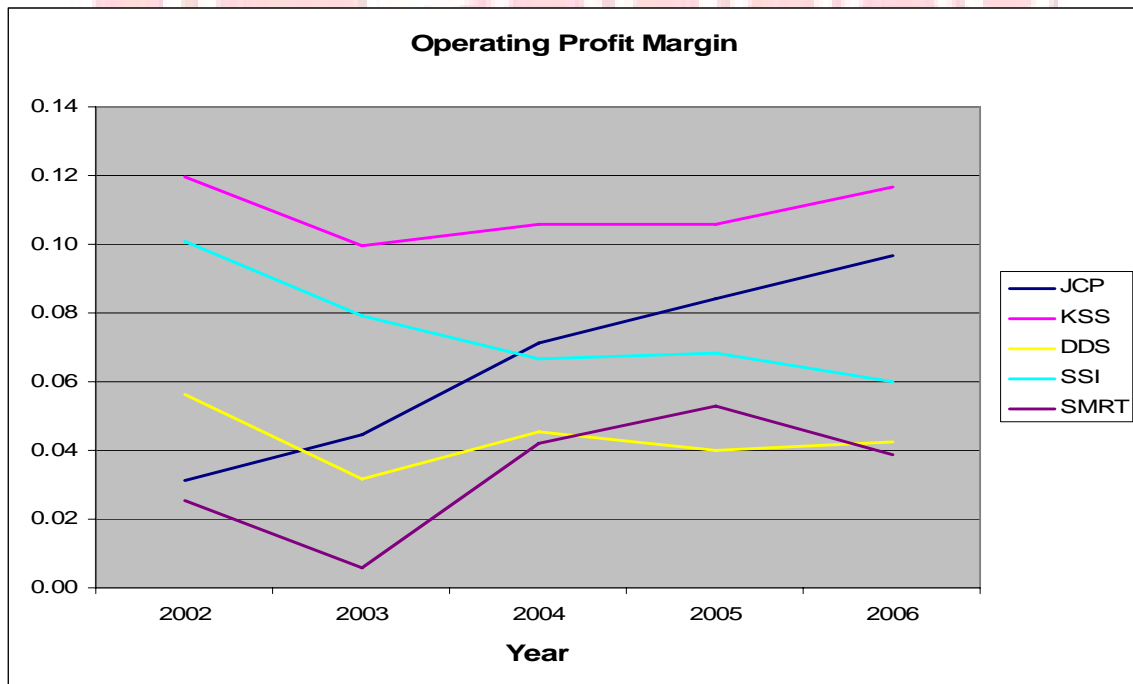
Gross Profit Margin



Gross profit margin is a ratio between a company's revenues minus its cost of goods sold compared to its revenues. The gross profit margin ratio provides a quantitative analysis of the company's ability to pay operating and other expenses and build future savings. A high ratio is preferred because it means the company has more money left after adjusting for costs of good sold to pay bills and reinvest in the company for the purpose of growth.

J. C. Penney has maintained a gross profit margin of approximately 0.39 over the past four years, which is inline with the industry average. Prior to 2004, J. C. Penney suffered lower gross profit margins due to the lagging performance of the company's subsidiary Eckerd Pharmacy, which the company sold to the Jean Coutu Group (PJC) Inc. (Coutu) and CVS Corporation and CVS Pharmacy, Inc. (together, CVS) in 2004. In comparison to the overall industry, J. C. Penney's performance is lined up with its competitors.

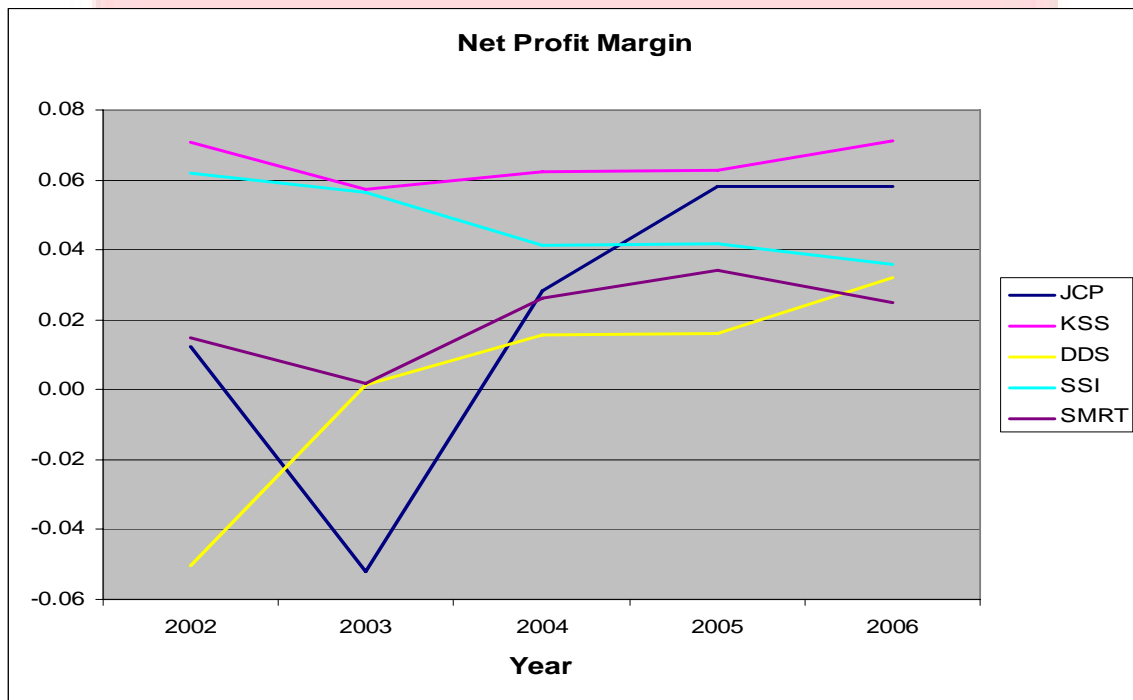
Operating Profit Margin



Operating profit margin compares the relationship between a firm's operating income and its sales. A higher operating profit margin indicates

operating efficiency because the firm is able to minimize its operating expenses. A lower operating profit margin is an indicator of poor operating efficiency from either declining sales or increasing operating expenses. Over the past five years, J. C. Penney's operating profit margin has been steadily increasing as other firms' operating profit margins are leveling out. This is inline with J. C. Penney's plan to increase operating efficiency and increase profitability.

Net Profit Margin

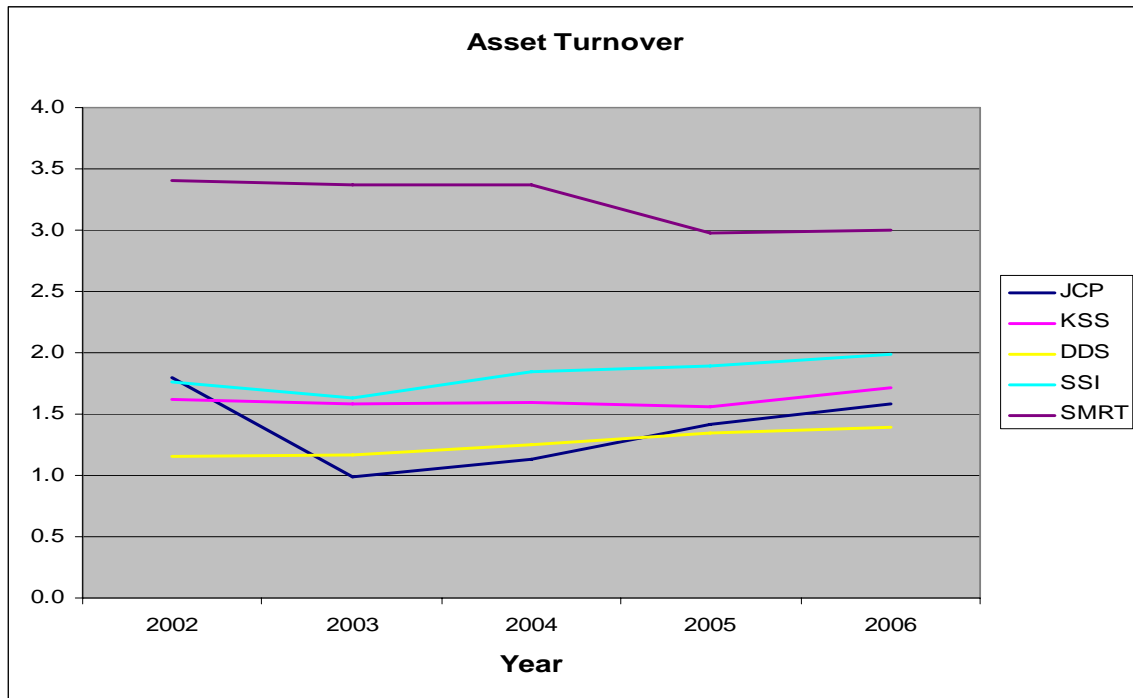


Net profit margin is a profitability ratio calculated by dividing net income by sales. "Net profit margin measures how much out of each dollar of sales a company actually keeps as earnings" (www.investopedia.com). A company's net profit margin does not say much about a firm's performance, but when it is compared to other companies within an industry, it proves to be very useful. A higher net profit margin indicates that a company has better cost controls compared to its competitors and is therefore more profitable.

J. C. Penney's net profit margin has been steadily increasing over the past five years, with the exception of 2003 when the company posted a loss of \$1.3

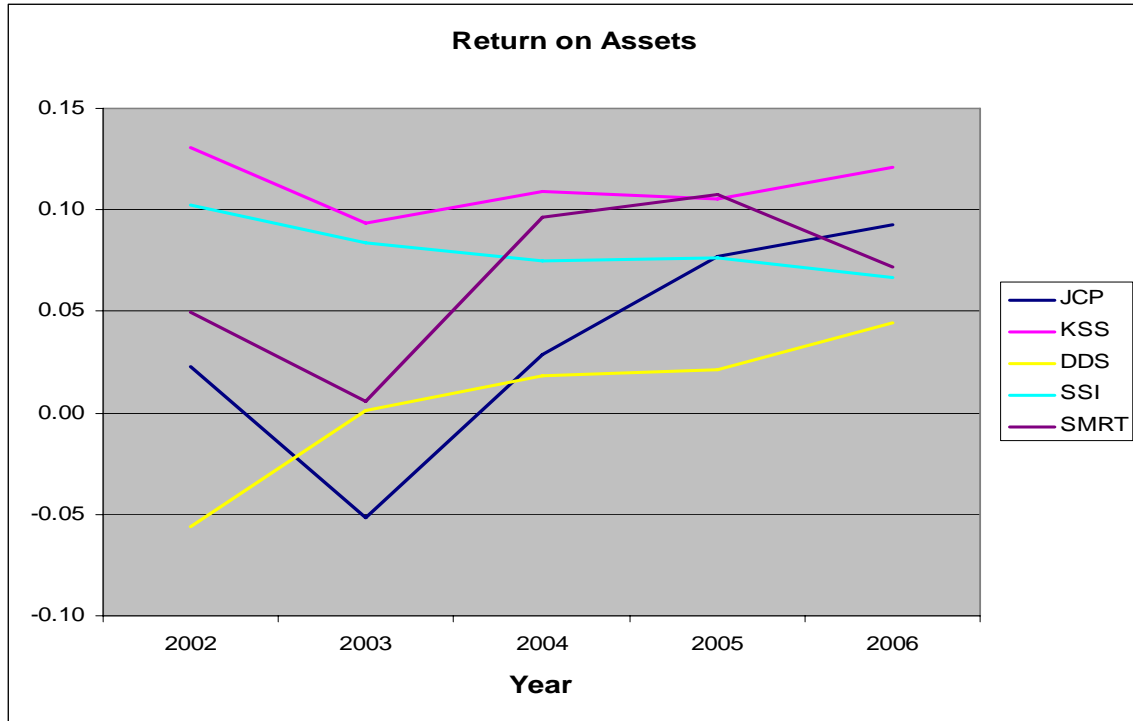
billion from the discontinued operations of Eckerd Pharmacy. Overall, J. C. Penney's performance is beating the industry average, demonstrating its higher profitability.

Asset Turnover Ratio



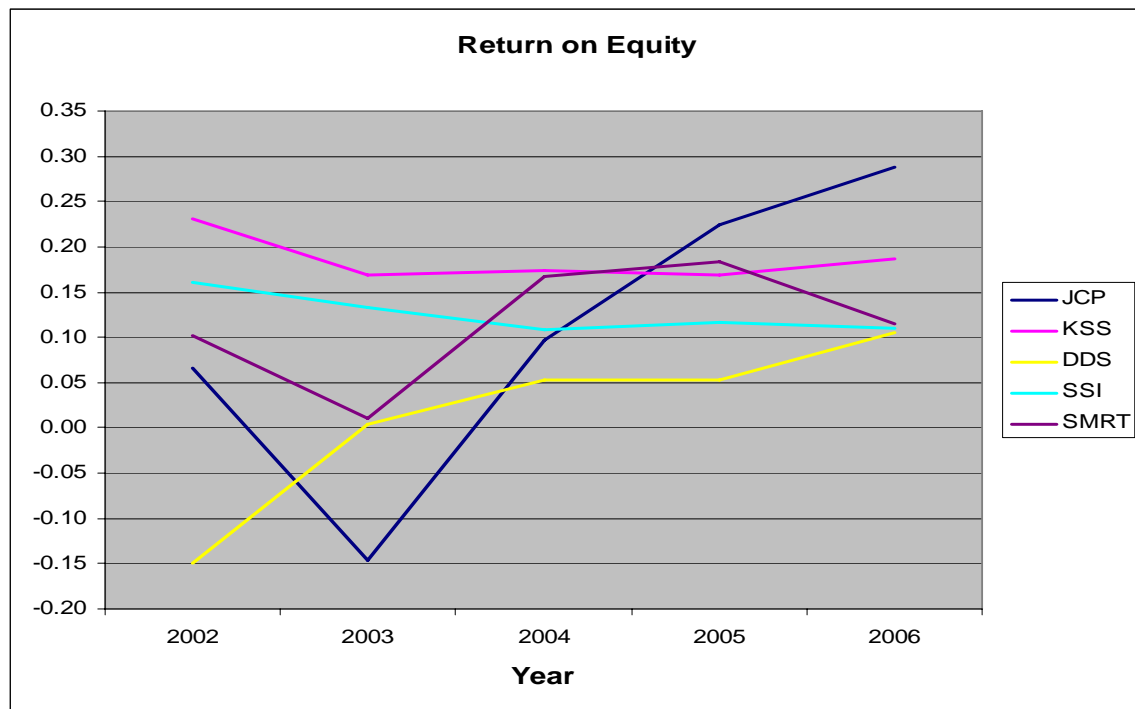
Asset turnover is the ratio of sales to average total assets. "Asset turnover is the measure of a firm's efficiency as using its assets in generating sales or revenue – the higher the number the better. It also indicates pricing strategy; companies with low profit margins tend to have high asset turnover, while those with high profit margins have low asset turnover" (investopedia.com). J. C. Penney's asset turnover falls in with the industry average. Stein Mart's asset turnover is slightly above average, again, due to the use of a variation of the just-in-time inventory method.

Return on Assets



Return on assets tells a percentage of total assets to net income. The higher the percentage is, the more favorable for the company. The industry average after 2004 is around six to seven percent. J. C. Penney matches and then surpasses this average in 2006 with a 9.3 percent return on assets. Year 2003 showed an unfavorable year due to losses in discontinued operations; however, as you can see, the company is recovering quite well.

Return on Equity



Return on equity shows that for every dollar of equity, a company has X amount of net income. Looking at the industry, from 2003 to 2006, there is a rise in this ratio across the board. J. C. Penney especially shows improvement, once more, due to the fact of sales of unprofitable companies in 2004. After the fact of these sales, the company then rises above the industry to a very favorable 28 percent.

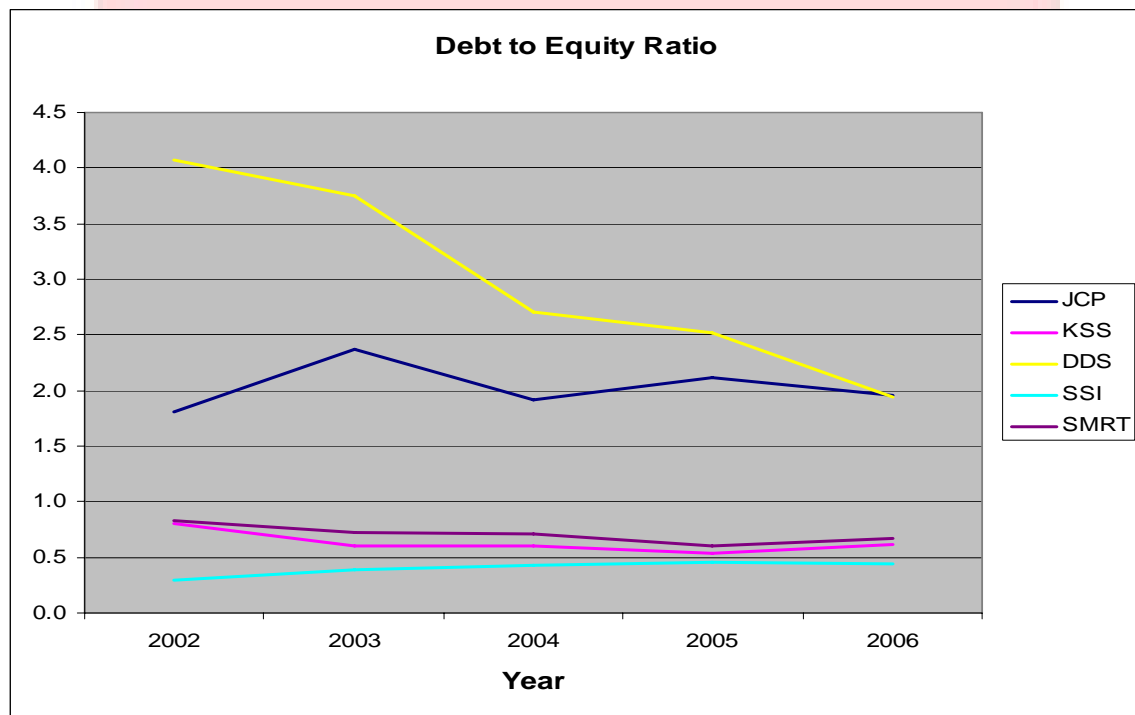
Conclusion

After assessing all profitability ratios, J. C. Penney, compared to the industry, is follow trend very well. After 2003, the company shows improvements in all areas with the exception of asset turnover. All of this can be attributed to the sale of Rojas Renner S. A. and Eckerd Pharmacy in 2003 and 2004, respectively. Not only does the company show improvements, but they also surpass averages in almost all areas. This shows that J. C. Penney is improving in profitability as they push forward into the future.

Capital Structure Analysis

When looking at capital structure ratios, the emphasis is on ability of a company to meet debt obligations in relation to owner's equity. The debt to equity, times interest earned, and debt service margin ratios explain where a company stands in this respect. The following analysis compares the J. C. Penney Company to the rest of the industry.

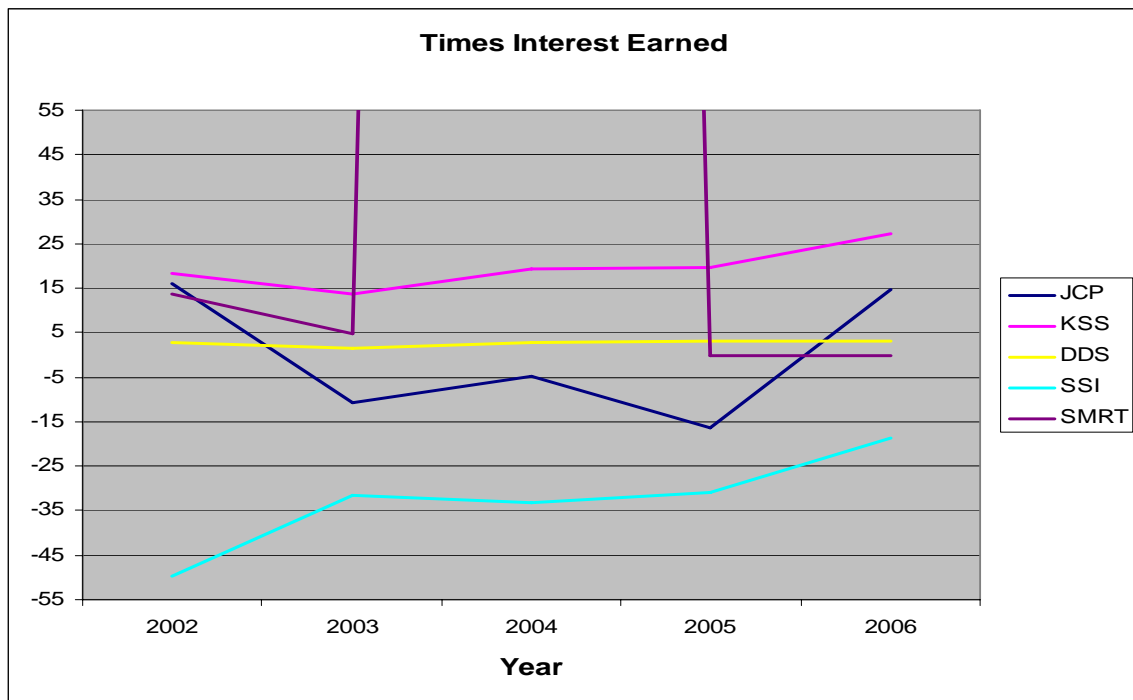
Debt to Equity



The debt to equity ratio shows how much debt a company has compared to equity. For every dollar in equity, this ratio shows how much debt a company has. The industry shows a fair average of debt to equity between .5 and 1.75. J. C. Penney and Dillard's have high debt to equity compared to Stein Mart, Kohl's, and Stage Stores widely ranging roughly from 1.75 all the way to 4.2. The Dillard's Company is having problems over the years dealing with restructuring, so this company has been all over the charts on most comparisons. Therefore, J. C. Penney compared to the industry has an unfavorable record of debt to

equity. As we follow the trend through the years, you can see the impact of the sale of Eckerd Pharmacy in 2004. Debt dropped, bringing the ratio down, but due to a push in change in brand lines and differentiation, the ratio rises again.

Times Interest Earned

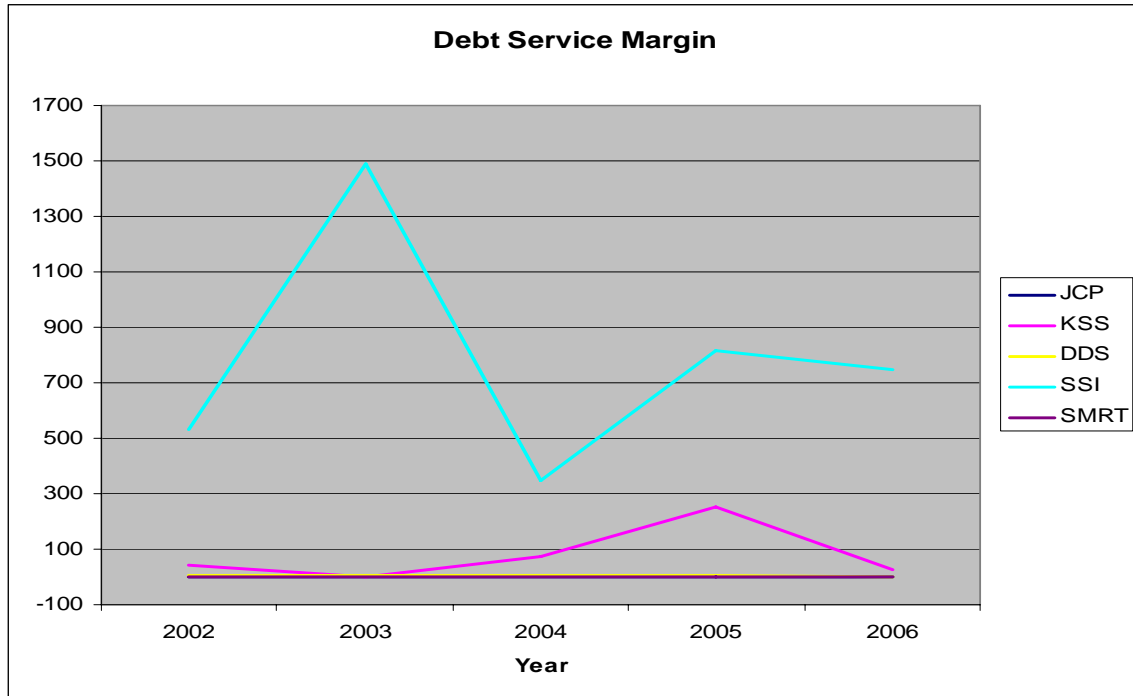


Time interest earned ratio tells that for every dollar in interest expense, the company has this amount in NIBIT to spend on interest and taxes. The industry numbers run around 2-15 times interest payable to NIBIT. In 2004, Stein Mart's times interest earned suddenly shot up because it reported net interest income of \$332,000 compared to interest expense of \$1.7 million for 2003. As a result of increased sales, decreased inventories, and ongoing expense control, Stein Mart has not borrowed on its revolving credit agreement since the first quarter of 2004, completely eliminating its interest expense (Stein Mart 2004 10-K).

J. C. Penney is unfavorable with this ratio. As we look at years 2003-2005, the company shows a negative times interest earned. This says that in these years, the company did not earn enough to cover their interest expenses;

however, in 2006, J. C. Penney showed improvements with a ratio of 14.78, coming closer to the industry average.

Debt Service Margin



The debt service margin ratio explains how well the company covers their debt service with cash flows created through operations. The industry average is fairly consistently low, when leaving out the obvious outlier, Stage Stores, Inc., which maintains substantially lower levels of long-term debt. This tells us that the industry is able to fund the cash for current notes payable but, on average, with little cash left at the end of the year. The debt service margin trend for J. C. Penney is low compared to other companies; the company barely covers current notes payable. A higher margin would of course be better for the company.

Conclusion

After reviewing the capital structure ratios of the J. C. Penney Company compared to industry averages, the company mostly follows the trend of the

industry. Unfavorable numbers present in the debt to equity ratio as well as times interest earned ratio compared to industry averages; although, fluctuation is higher in at least one other company in both aspects. Because of these reasons, the company does not raise any red flags, but it also shows that the J. C. Penney is not an industry leader in respect to the ability to pay debts with shareholder's equity. This is found to be caused by the investments in restructuring after the sales of Eckerd Pharmacy and Rojas Renner S. A. as well as the push of new brands and labels by the company.

IGR/SGR Analysis

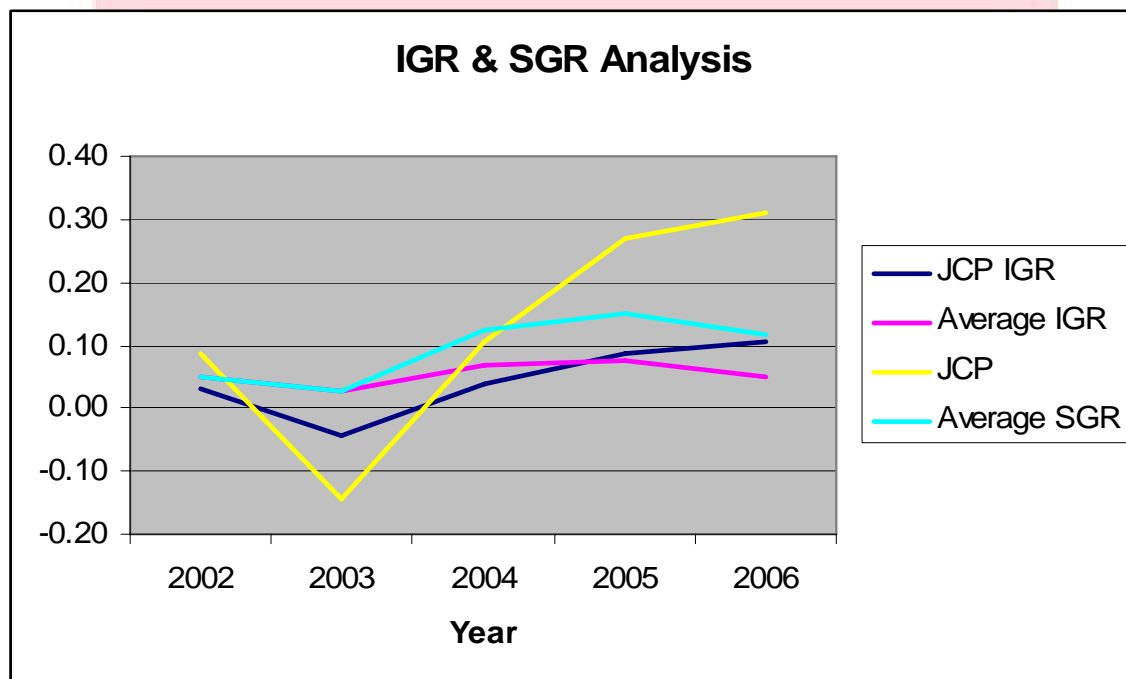
Determining a firm's estimated growth rates helps paint a picture of whether or not they will continue to be profitable in the future. The growth rate of a firm is dependent upon a number of factors including their returns on assets and equity, as well as their dividend payout and debt to equity ratios.

Internal Growth Rate

A firm's internal growth rate (IGR) determines how much a company can grow their asset base that can be sustained all with internal financing. This means that the firm is trying to increase their assets without financing them with debt. They are trying to finance future projects completely with funds generated from the firms operations and not borrow any excessive amounts of funding from banks or any kind of financial institutions. J. C. Penney has a relatively small IGR compared to firms such as Kohl's and Stage Stores, Inc. They are obviously funding more of their future projects with borrowed versus internally generated funding than these competitors. However, their IGR is higher than that of Dillard's, so they are funding less of their future projects with debt and more with internal funds. J. C. Penney's IGR is pretty consistent with that of Stein Mart. They both are keeping a steady balance between funding with debt and internal financing.

Sustainable Growth Rate

Sustainable growth rate (SGR) is the maximum rate of growth that a firm can achieve without adding additional debt. If a firm exceeds this limit they will have to increase their financial leverage by borrowing more funds to maintain this level of growth. Since SGR is determined based on the company's internal growth rate, J. C. Penney holds the same amount of sustainable growth as it did with IGR compared to its competition. They have a small SGR compared to Kohl's and Stage Stores, Inc. and a higher SGR than Dillard's. They stay constant with Stein Mart meaning that they are increasing their financial leverage at about the same rate.



J. C. Penney's internal and sustainable growth rates determine the amount of debt they will increase for funding of future projects. These are important ratios because they determine the level of future profitability of the company. When the firm increases their financial leverage by acquiring more debt for financing, they will inadvertently reduce the level of future profitability because they have increased future financial obligations to pay. If the IGR and SGR ratios are higher, then they will have fewer obligations and therefore will be

more profitable in the future. Since J. C. Penney's IGR and SGR are a relatively small compared to their competitors, it explains that they are in the process of acquiring more debt than these other companies acquire. This is probably because they are currently maintaining an aggressive growth plan. Once this plan is complete, they will have the ability to increase these numbers thus maintaining a higher level of profitability.

Financial Statement Forecasting

Financial statement forecast analysis is a process designed to provide insight into the actual valuation of a firm. It estimates a firm's future value based on historical financial statements given in a firm's annual 10-K reports. We assumed the sustainability of J. C. Penney's productivity performance based on the annual filings over the past five years. Based on these assumptions, we forecasted J. C. Penney's income statement, balance sheet, and statement of cash flows for the next 10 years. To forecast the income statement, we based our assumptions on a mix of J. C. Penney's historical average growth rates and those of the industry. When forecasting the balance sheet, we utilized not only growth rates but also accounts receivable turnover, inventory turnover, asset turnover, and current ratios for J. C. Penney. We then used the manipulation diagnostics for core expenses in relation to CFFO to base our assumptions for the statement of cash flows. These ratios are CFFO/OI and CFFO/NI.

Income statement Analysis

To forecast the income statement, we looked at the financials in many different aspects. First, we found the average percentages of all line items compared to net sales. Some of this information was found irrelevant because of many industry fluctuations on the years 2002 and 2003. In addition, because J. C. Penney sold Eckerd in April of 2004, we decided that 2004 did not give a fair view of the future of the financials. Because of these deficiencies, we took an

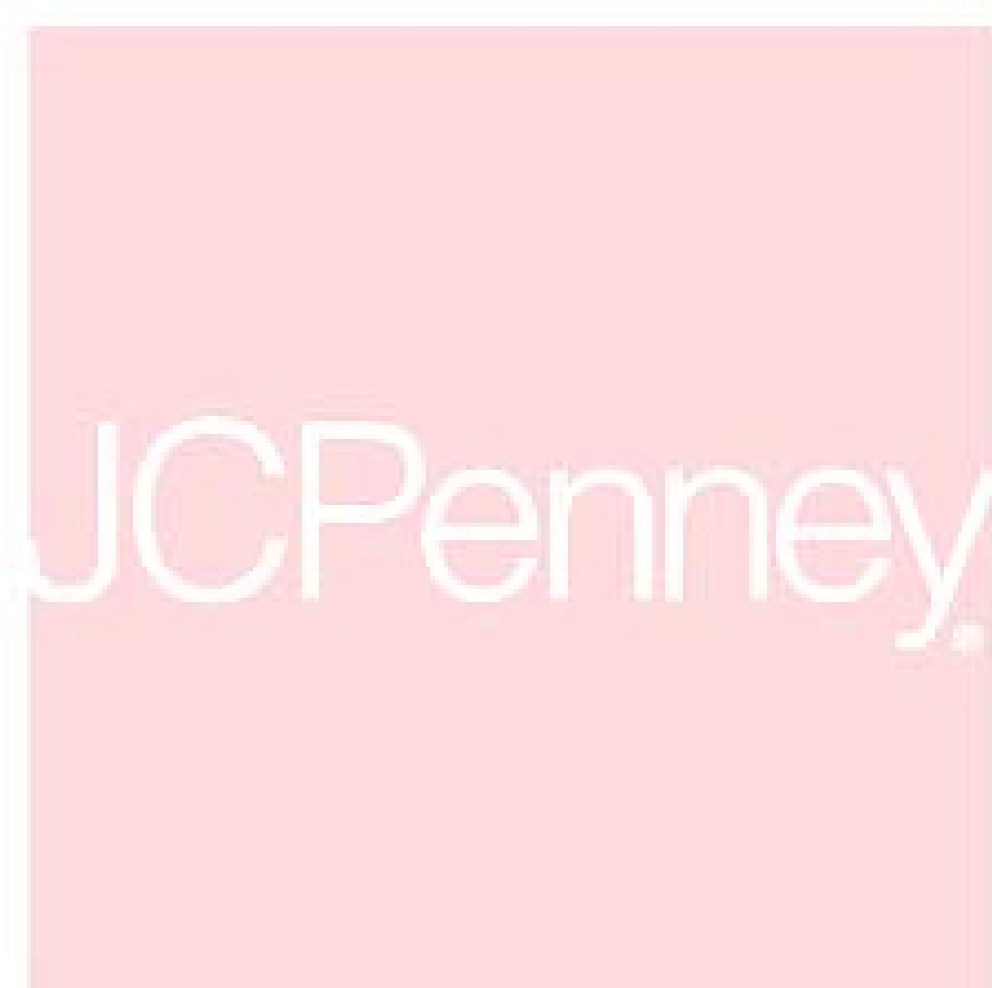
average of only years 2005 and 2006 for J. C. Penney and started from there. This two-year average seemed like a very reasonable starting point, but because only two years were used to average out future potential of the income statement, we did an industry average which included J. C. Penney as well as four other competitors. This industry average, compared to J. C. Penney's relevant two-year average, gave a jump-start to how we decided on which values to use in forecasting the next 10 years.

Going through the income statement, all line items that could be appropriately forecasted were considered. Because of the company turn-around after 2004, as well as new brand launches, we went for a percentage that was higher than J. C. Penney historical two-year average of 3.96 percent. After benchmarking this with industry average of 9.52 percent, we found that a 6.00 percent growth rate was fair and very reasonable. From year 2006 to 2007, sales forecasted grew from a published \$19,903 million to \$21,097 million. This 6 percent growth percentage is lower than the industry average; however, we felt like this is an appropriate number considering Stage Stores had a higher than normal growth rate, therefore raising the overall average. This high rate was because Stage Stores opened more new stores over the last year than most firms in the industry.

The cost of goods sold was determined to also be lower than not only the industry average, 67.82 percent, but also the J. C. Penney five year averages, 63.05 percent. This again is due to the fact of the company sold by J. C. Penney in 2004. After this, sales and cost of sales went down for obvious reasons. The two-year relevant average came to 60.71 percent. Looking at all of these numbers, we chose a number higher than our two-year average to match the increase in sales of 61.00 percent. It is higher because as sales increase every year, the cost of sales will be a higher number in the long run.

For the remainder of the forecasted line items, comparisons between the industry, J. C. Penney five-year, and J. C. Penney two-year averages were considered just as in sales and cost of sales for the values chosen. We felt that

our predicted future values show optimism for steady growth over the next 10 years because of the analysis of the forward-looking vision of the company itself.



(reported in millions)

Annual Income Statement	2002	2003	2004	2005	2006	Average	Avg 05-06	Ind. Avg.	Assumed	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Retail sales, net	\$32,347	\$17,786	\$18,424	\$18,781	\$19,903	100.00%	100.00%	100.00%	6.00%	\$21,097	\$22,363	\$23,705	\$25,127	\$26,635	\$28,233	\$29,927	\$31,722	\$33,626	\$35,643
Cost of goods sold	\$22,573	\$11,166	\$11,285	\$11,405	\$12,078	-6.49%	3.96%	9.52%	61.00%	\$12,869	\$13,641	\$14,460	\$15,328	\$16,247	\$17,222	\$18,255	\$19,351	\$20,512	\$21,742
Gross margin	\$9,774	\$6,620	\$7,139	\$7,376	\$7,825	63.05%	60.71%	67.82%	39.00%	\$8,228	\$8,722	\$9,245	\$9,800	\$10,388	\$11,011	\$11,671	\$12,372	\$13,114	\$13,901
Selling, general & administrative expenses	\$8,667	\$5,830	\$5,827	\$5,799	\$5,521	36.95%	39.29%	32.81%	29.25%	\$6,171	\$6,541	\$6,934	\$7,350	\$7,791	\$8,258	\$8,754	\$9,279	\$9,836	\$10,426
Total operating expenses	\$8,667	\$5,830	\$5,827	\$5,799	\$5,903	30.35%	30.27%	26.69%	30.25%	\$6,382	\$6,765	\$7,171	\$7,601	\$8,057	\$8,540	\$9,053	\$9,596	\$10,172	\$10,782
Operating income	\$1,107	\$790	\$1,312	\$1,577	\$1,922	6.61%	9.03%	6.53%	8.75%	\$1,846	\$1,957	\$2,074	\$2,199	\$2,331	\$2,470	\$2,619	\$2,776	\$2,942	\$3,119
Total costs & expenses	\$31,763	\$17,336	\$17,442	\$17,403	\$18,179	94.87%	92.00%	93.56%	90.50%	\$19,093	\$20,239	\$21,453	\$22,740	\$24,104	\$25,551	\$27,084	\$28,709	\$30,431	\$32,257
Income tax expense	\$213	\$182	\$353	\$467	\$658	1.88%	2.90%	2.05%	3.50%	\$738	\$783	\$830	\$879	\$932	\$988	\$1,047	\$1,110	\$1,177	\$1,248
Net income (loss)	\$405	(\$928)	\$524	\$1,088	\$1,153	2.09%	5.79%	3.13%	6.00%	\$1,266	\$1,342	\$1,422	\$1,508	\$1,598	\$1,694	\$1,796	\$1,903	\$2,018	\$2,139
Common Size Income Statement	2002	2003	2004	2005	2006	Average	Avg 05-06	Ind. Avg.	Assumed	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Sales Growth Percent	1.07%	-45.01%	3.59%	1.94%	5.97%	-6.49%	3.96%	9.52%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%
Cost of goods sold	69.78%	62.78%	61.25%	60.73%	60.68%	63.05%	60.71%	67.82%	61.00%	61.00%	61.00%	61.00%	61.00%	61.00%	61.00%	61.00%	61.00%	61.00%	61.00%
Gross margin	30.22%	37.22%	38.75%	39.27%	39.32%	36.95%	39.29%	32.81%	39.00%	39.00%	39.00%	39.00%	39.00%	39.00%	39.00%	39.00%	39.00%	39.00%	39.00%
Selling, general & administrative expenses	26.79%	32.78%	31.63%	30.88%	27.74%	29.96%	29.31%	24.87%	29.25%	29.25%	29.25%	29.25%	29.25%	29.25%	29.25%	29.25%	29.25%	29.25%	29.25%
Total operating expenses	26.79%	32.78%	31.63%	30.88%	29.66%	30.35%	30.27%	26.69%	31.00%	31.00%	31.00%	31.00%	31.00%	31.00%	31.00%	31.00%	31.00%	31.00%	31.00%
Operating income	3.42%	4.44%	7.12%	8.40%	9.66%	6.61%	9.03%	6.53%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%	10.00%
Total costs & expenses	98.19%	97.47%	94.67%	92.66%	91.34%	94.87%	92.00%	93.56%	90.50%	90.50%	90.50%	90.50%	90.50%	90.50%	90.50%	90.50%	90.50%	90.50%	90.50%
Income tax expense	0.66%	1.02%	1.92%	2.49%	3.31%	1.88%	2.90%	2.05%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%
Net income (loss)	1.25%	-5.22%	2.84%	5.79%	5.79%	2.09%	5.79%	3.13%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%	6.00%

Balance Sheet Analysis

When determining the future profitability of J. C. Penney, we began by creating a common-sized balance sheet to get a general idea of how the firm was performing compared to the industry. We then used the industry averages as a benchmark and compared their numbers to those of J. C. Penney's. This aided in the determination of which ratios to utilize in order to provide us with the best estimations for the forecasting process.

We began by looking at the asset portion of the balance sheet, ultimately deciding that our total assets line was what we should use to base all of our other asset estimations. This determination was decided upon because obviously current and non-current assets should be combined and result in total assets. Looking at the industry average, we agreed that it would not be the best number to base our assumptions on because our firm is relatively larger than that of most within the industry and should therefore have more assets.

While looking at our asset turnover, which was determined to be 1.584, we noticed a trend over the previous two years and decided to use it in comparison to our already forecasted sales for our income statement analysis. Once we determined our total assets, we then decided upon the percentage of current and non-current assets based off our forecasted total assets.

Breaking up these two portions, we began analyzing total current assets. We determined cash and short-term investments to be an average of the previous two years. They were higher than the industry average because we have continuously been above the industry average. Because of the fact that our company is larger than others within the retail industry, we agreed that this was a reasonable number. Accounts receivable turnover was based on the last year and applied to our forecasted sales from the income statement. We used the most recent A/R turnover of 75.68 because it was approximately where the industry average should be. The inventory turnover ratio used was based on the number given for the last year because it was at a stable level for the previous two to three years. We manipulated this equation to come up with inventory by using our already forecasted cost of goods sold. Total non-current assets was then determined based on our estimations of total current assets. Property and equipment was assumed to be increasing because of the plans for expansion of our company within the next few years. We are thus converging toward the industry average.

We then began to look at the equity portion of the balance sheet. We began by looking at return on equity. We used an average of the last two years because, compared to the industry, there seems to be a convergence. We determined that J. C. Penney would remain constant at the level of 28.77 because of this industry convergence. Retained earnings were determined by taking the forecasted net income from the income statement and subtracting out the forecasted dividends. Since we cannot forecast the number of share we will have in the future, we used the 226 million outstanding shares we already have.

We then backed into total liabilities because of how liabilities plus equity equals assets. We decided that these numbers should balance out. We used the current ratio to determine what our current liabilities should be. We determined that trade payables should be a little higher than that of the average found on our common-sized balance sheet. This is because we are increasing at an incremental level to meet industry average. We decided that the same process and reasoning should be applied to our gift cards. Once the current liabilities were determined, we began to analyze our total non-current liabilities. Total accrued expenses have had consistent ratios over the past five years so we slightly increased it to meet the industry average. Notes payable have had a consistent percentage of 20 for the past five years. We determined that this percentage should be kept because once amounts get paid off we will have more notes payable due to our accelerated growth plan.

(reported in millions)																
Balance Sheet	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	
Cash & short-term investments	\$2,474	\$2,994	\$4,687	\$3,016	\$2,747	\$3,056	\$3,239	\$3,433	\$3,639	\$3,858	\$4,089	\$4,335	\$4,595	\$4,870	\$5,163	
Receivables, net	\$705	\$233	\$404	\$270	\$263	\$279	\$296	\$313	\$332	\$352	\$373	\$395	\$419	\$444	\$471	
Merchandise inventories	\$4,945	\$3,156	\$3,169	\$3,210	\$3,400	\$3,623	\$3,840	\$4,071	\$4,315	\$4,574	\$4,848	\$5,139	\$5,447	\$5,774	\$6,121	
Prepaid expenses	\$229	\$130	\$167	\$206	\$238											
Total current assets	\$8,353	\$6,513	\$8,427	\$6,702	\$6,648	\$7,076	\$7,501	\$7,951	\$8,428	\$8,933	\$9,469	\$10,037	\$10,640	\$11,278	\$11,955	
Land & buildings	\$2,940	\$2,760	\$2,896	\$3,045	\$3,378											
Furniture & fixtures	\$3,946	\$2,203	\$2,145	\$2,078	\$2,104											
Leasehold improvements	\$1,268	\$674	\$674	\$722	\$795											
Accumulated depreciation	\$3,253	\$2,122	\$2,077	\$2,097	\$2,115											
Property & equipment, net	\$4,901	\$3,515	\$3,638	\$3,748	\$4,162	\$4,422	\$4,695	\$4,984	\$5,291	\$5,617	\$5,963	\$6,330	\$6,720	\$7,134	\$7,573	
Prepaid pension		\$1,320	\$1,538	\$1,469	\$1,235											
Goodwill & other intangible assets, net	\$2,798	\$42														
Real estate investments	\$106	\$169	\$192	\$270	\$350											
Leveraged lease investments	\$131	\$134	\$139	\$135	\$140											
Capitalized software, net	\$228	\$97	\$99	\$89	\$95											
Goodwill - Renner			\$43													
Deferred catalog book costs	\$73	\$77														
Debt issuance costs, net	\$46	\$52	\$31	\$24	\$21											
Prepaid pension	\$1,172															
Other assets	\$59	\$27	\$20	\$24	\$22											
Total other assets	\$1,815	\$556	\$524	\$542	\$628											
Assets of discontinued operations		\$6,354														
Total noncurrent assets	\$9,514	\$11,787	\$5,700	\$5,759	\$6,025	\$6,245	\$6,619	\$7,016	\$7,437	\$7,884	\$8,357	\$8,858	\$9,390	\$9,953	\$10,550	
Total assets	\$17,867	\$18,300	\$14,127	\$12,461	\$12,673	\$13,321	\$14,120	\$14,967	\$15,865	\$16,817	\$17,826	\$18,896	\$20,029	\$21,231	\$22,505	
Trade payables	\$1,792	\$1,167	\$1,200	\$1,171	\$1,366	\$1,440	\$1,531	\$1,628	\$1,730	\$1,840	\$1,956	\$2,079	\$2,210	\$2,349	\$2,497	
Accrued salaries, vacation & bonus	\$570	\$409	\$443	\$453	\$455											
Customer gift cards/certificates	\$173	\$179	\$207	\$219	\$231	\$243	\$255	\$268	\$282	\$296	\$312	\$328	\$346	\$365	\$384	
Taxes other than income taxes			\$125	\$74	\$116											
Capital expenditures payable				\$47	\$88											
Interest payable	\$122	\$132	\$107	\$95	\$84											
Current portion of retirement plan liability					\$74											
Advertising payables	\$187	\$79	\$78	\$99	\$93											
Current portion of workers' compensation & ge	\$99	\$63	\$68	\$72	\$67											
Occupancy & rent-related payables	\$91			\$51	\$46											
Common dividends payable	\$34	\$35	\$35	\$29	\$41											
Reserves for discontinued operations			\$221	\$79	\$34											
Taxes payable	\$123	\$119	\$79													
Other accrued expenses & other curr liabls	\$432	\$368	\$352	\$344	\$363											
Total accrued expenses & oth current liabls			\$1,766	\$1,562	\$1,692	\$1,633	\$1,731	\$1,835	\$1,945	\$2,062	\$2,185	\$2,316	\$2,455	\$2,603	\$2,759	
Accounts payable & accrued expenses	\$3,791	\$2,551														
Current maturities of long term debt	\$275	\$242	\$459	\$21	\$434											
Income taxes payable				\$8												
Short-term debt	\$13	\$18	\$22													
Deferred taxes	\$80	\$943														
Total current liabilities	\$4,159	\$3,754	\$3,447	\$2,762	\$3,492	\$3,717	\$3,940	\$4,176	\$4,427	\$4,692	\$4,974	\$5,272	\$5,589	\$5,924	\$6,280	
Notes	\$1,928	\$2,165	\$1,857	\$1,763	\$1,763	\$1,633	\$1,731	\$1,835	\$1,945	\$2,062	\$2,185	\$2,316	\$2,455	\$2,603	\$2,759	
Debentures	\$1,525	\$1,525	\$1,525	\$1,369	\$1,369											
Notes & debentures	\$3,453	\$3,690	\$3,382	\$3,132	\$3,132											
Medium-term notes	\$493	\$493	\$493	\$300	\$300											
Convertible subordinated notes	\$650	\$650														
Sinking fund debentures	\$392	\$313														
Original issue discount debentures	\$156	\$167														
Equipment financing notes	\$25	\$21	\$15	\$10	\$4											
Total notes & debentures			\$3,890	\$3,442	\$3,436											
Capital lease obligs & other long-term debt	\$46	\$22	\$33	\$23	\$8											
Total long-term debt, including current matur			\$3,923	\$3,465	\$3,444											
Less: current maturities	\$275	\$242	\$459	\$21	\$434											
Long-term debt	\$4,940	\$5,114	\$3,464	\$3,444	\$3,010											
Deferred taxes	\$1,391	\$1,217	\$1,318	\$1,287	\$1,206											
Retirement benefit plan liabilities			\$634	\$590	\$324											
Reserves for discontinued operations			\$114	\$54	\$51											
Other liabilities	\$1,007	\$804	\$114	\$31	\$30											
Total other liabilities			\$1,042	\$961	\$677											
Liabilities of discontinued operations		\$1,986														
Total NonCurrent Liabilities	\$7,338	\$9,121	\$5,824	\$5,692	\$4,893	\$4,657	\$4,937	\$5,233	\$5,547	\$5,880	\$6,232	\$6,606	\$7,003	\$7,423	\$7,868	
Total liabilities	\$11,497	\$12,875	\$9,271	\$8,454	\$8,385	\$8,374	\$8,876	\$9,409	\$9,974	\$10,572	\$11,206	\$11,879	\$12,591	\$13,347	\$14,148	
Preferred stock	\$333	\$304														
Common stock & additional paid-in capital	\$3,423	\$3,531	\$4,176	\$3,479	\$3,542											
Deferred stock compensation																
Reinvested earnings	\$2,817	\$1,728	\$812	\$512	\$922	\$1,085	\$1,161	\$1,241	\$1,306	\$1,396	\$1,492	\$1,572	\$1,679	\$1,794	\$1,915	
Foreign currency translation	(\$164)	(\$115)	(\$104)													
Non-qualified plan minimum liability adjustme	(\$58)	(\$82)	(\$102)	(\$102)												
Net unrealized gains on investments	\$19	\$60	\$74	\$118	\$166											
Net actuarial gain/(loss) & prior service (co					(\$342)											
Other comprehensive (loss) from discount opers		(\$1)														
Accumulated other comprehensive income (loss)	(\$203)	(\$138)	(\$132)	\$16	(\$176)											
Total stockholders' equity	\$6,370	\$5,425	\$4,856	\$4,007	\$4,288	\$4,947	\$5,243	\$5,558	\$5,891	\$6,245	\$6,620	\$7,017	\$7,438	\$7,884	\$8,357	

Common Size Balance Sheet	2002	2003	2004	2005	2006	AVG	AVG 05-06	Industry Average	Assumed
Cash & short-term investments	13.85%	16.36%	33.18%	24.20%	21.68%	21.85%	22.94%	10.68%	22.94%
Receivables, net	3.95%	1.27%	2.86%	2.17%	2.08%	2.46%	2.12%	4.31%	75.68
Merchandise inventories	27.68%	17.25%	22.43%	25.76%	26.83%	23.99%	26.29%	36.03%	3.552
Prepaid expenses	1.28%	0.71%	1.18%	1.65%	1.88%	1.88%	1.34%	1.77%	
Total current assets	46.75%	35.59%	59.65%	53.78%	52.46%	49.65%	53.12%	52.07%	53.12%
Land & buildings	16.45%	15.08%	20.50%	24.44%	26.66%	20.63%	25.55%		
Furniture & fixtures	22.09%	12.04%	15.18%	16.68%	16.60%	16.52%	16.64%		
Leasehold improvements	7.10%	3.68%	4.77%	5.79%	6.27%	5.52%	6.03%		
Accumulated depreciation	18.21%	11.60%	14.70%	16.83%	16.69%	15.60%	16.76%		
Property & equipment, net	27.43%	19.21%	25.75%	30.08%	32.84%	27.06%	31.46%	42.61%	33.20%
Prepaid pension	0.00%	7.21%	10.89%	11.79%	9.75%	7.93%	10.77%		
Goodwill & other intangible assets, net	15.66%	0.23%	0.00%	0.00%	0.00%	3.18%	0.00%		
Real estate investments	0.59%	0.92%	1.36%	2.17%	2.76%	1.56%	2.46%		
Leveraged lease investments	0.73%	0.73%	0.98%	1.08%	1.10%	0.93%	1.09%		
Capitalized software, net	1.28%	0.53%	0.70%	0.71%	0.75%	0.79%	0.73%		
Goodwill - Renner	0.00%	0.00%	0.30%	0.00%	0.00%	0.06%	0.00%		
Deferred catalog book costs	0.41%	0.42%	0.00%	0.00%	0.00%	0.17%	0.00%		
Debt issuance costs, net	0.26%	0.28%	0.22%	0.19%	0.17%	0.22%	0.18%		
Prepaid pension	6.56%	0.00%	0.00%	0.00%	0.00%	1.31%	0.00%		
Other assets	0.33%	0.15%	0.14%	0.19%	0.17%	0.20%	0.18%		
Total other assets	10.16%	3.04%	3.71%	4.35%	4.96%	5.24%	4.65%		
Assets of discontinued operations	0.00%	34.72%	0.00%	0.00%	0.00%	6.94%	0.00%		
Total noncurrent assets	53.25%	64.41%	40.35%	46.22%	47.54%	50.35%	46.88%	47.60%	
Total assets	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%		1.584
Trade payables	15.59%	9.06%	12.94%	13.85%	16.29%	13.55%	15.07%	26.14%	17.20%
Accrued salaries, vacation & bonus	4.96%	3.18%	4.78%	5.36%	5.43%	4.74%	5.39%		
Customer gift cards/certificates	1.50%	1.39%	2.23%	2.59%	2.75%	2.09%	2.67%	5.63%	5%
Taxes other than income taxes	0.00%	0.00%	1.35%	0.88%	1.38%	0.72%	1.13%		
Capital expenditures payable	0.00%	0.00%	0.00%	0.56%	1.05%	0.32%	0.80%		
Interest payable	1.06%	1.03%	1.15%	1.12%	1.00%	1.07%	1.06%		
Current portion of retirement plan liability	0.00%	0.00%	0.00%	0.00%	0.88%	0.18%	0.44%		
Advertising payables	1.63%	0.61%	0.84%	1.17%	1.11%	1.07%	1.14%		
Current portion of workers' compensation & ge	0.86%	0.49%	0.73%	0.85%	0.80%	0.75%	0.83%		
Occupancy & rent-related payables	0.79%	0.00%	0.00%	0.60%	0.55%	0.39%	0.58%		
Common dividends payable	0.30%	0.27%	0.38%	0.34%	0.49%	0.36%	0.42%		
Reserves for discontinued operations	0.00%	0.00%	2.38%	0.93%	0.41%	0.74%	0.67%		
Taxes payable	1.07%	0.92%	0.85%	0.00%	0.00%	0.57%	0.00%		
Pharmacy payables	1.14%	0.00%	0.00%	0.00%	0.00%	0.23%	0.00%		
Restructuring reserves	0.32%	0.00%	0.00%	0.00%	0.00%	0.06%	0.00%		
Funds due for common stock repurchases	0.00%	0.00%	0.55%	0.00%	0.00%	0.11%	0.00%		
Other accrued expenses & other curr liabils	3.76%	2.86%	3.80%	4.07%	4.33%	3.76%	4.20%		
Total accrued expenses & oth current liabils	0.00%	0.00%	19.05%	18.48%	20.18%	19.23%	19.33%	25.69%	19.50%
Accounts payable & accrued expenses	32.97%	19.81%	0.00%	0.00%	0.00%	10.56%	0.00%		
Current maturities of long term debt	2.39%	1.88%	4.95%	0.25%	5.18%	2.93%	2.71%		
Income taxes payable	0.00%	0.00%	0.00%	0.09%	0.00%	0.02%	0.05%		
Short-term debt	0.11%	0.14%	0.24%	0.00%	0.00%	0.10%	0.00%		
Deferred taxes	0.70%	7.32%	0.00%	0.00%	0.00%	1.60%	0.00%		
Total current liabilities	36.17%	29.16%	37.18%	32.67%	41.65%	35.37%	37.16%	52.76%	2.100
Notes	16.77%	16.82%	20.03%	20.85%	21.03%	19.10%	20.94%	12.16%	20.00%
Debentures	13.26%	11.84%	16.45%	16.19%	16.33%	14.82%	16.26%		
Notes & debentures	30.03%	28.66%	36.48%	37.05%	37.35%	33.91%	37.20%	23.61%	
Medium-term notes	4.29%	3.83%	5.32%	3.55%	3.58%	4.11%	3.56%		
Convertible subordinated notes	5.65%	5.05%	0.00%	0.00%	0.00%	2.14%	0.00%		
Sinking fund debentures	3.41%	2.43%	0.00%	0.00%	0.00%	1.17%	0.00%		
Original issue discount debentures	1.36%	1.30%	0.00%	0.00%	0.00%	0.53%	0.00%		
Equipment financing notes	0.22%	0.16%	0.16%	0.12%	0.05%	0.14%	0.08%		
Total notes & debentures	0.00%	0.00%	41.96%	40.71%	40.98%	24.73%	40.85%		
Capital lease obligs & other long-term debt	0.40%	0.17%	0.36%	0.27%	0.10%	0.26%	0.18%		
Total long-term debt, including current matur	0.00%	0.00%	42.31%	40.99%	41.07%	24.87%	41.03%		
Less: current maturities	2.39%	1.88%	4.95%	0.25%	5.18%	2.93%	2.71%		
Long-term debt	42.97%	39.72%	37.36%	40.74%	35.90%	39.34%	38.32%		
Deferred taxes	12.10%	9.45%	14.22%	15.22%	14.38%	13.07%	14.80%		
Retirement benefit plan liabilities	0.00%	0.00%	6.84%	6.98%	3.86%	3.54%	5.42%		
Long-term portion of workers' compensation &	0.00%	0.00%	1.69%	1.94%	1.81%	1.09%	1.88%		
Developer/tenant allowances	0.00%	0.00%	1.20%	1.44%	1.43%	0.81%	1.44%		
Reserves for discontinued operations	0.00%	0.00%	1.23%	0.64%	0.61%	0.50%	0.62%		
Other liabilities	0.00%	0.00%	0.28%	0.37%	0.36%	0.20%	0.36%		
Total other liabilities	0.00%	0.00%	11.24%	11.37%	8.07%	6.14%	9.72%		
Liabilities of discontinued operations	0.00%	15.43%	0.00%	0.00%	0.00%	3.09%	0.00%		
Total NonCurrent Liabilities	63.83%	70.84%	62.82%	67.33%	58.35%	64.63%	62.84%	46.85%	
Total liabilities	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%		
Preferred stock	5.23%	5.60%	0.00%	0.00%	0.00%	2.17%	0.00%		
Common stock & additional paid-in capital	53.74%	65.09%	86.00%	86.82%	82.60%	74.85%	84.71%		
Deferred stock compensation	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%		
Reinvested earnings	44.22%	31.85%	16.72%	12.78%	21.50%	25.42%	17.14%	63.96%	25%
Foreign currency translation	-2.57%	-2.12%	-2.14%	0.00%	0.00%	-1.37%	0.00%		
Non-qualified plan minimum liability adjustme	-0.91%	-1.51%	-2.10%	-2.55%	0.00%	-1.41%	-1.27%		
Net unrealized gains on investments	0.30%	1.11%	1.52%	2.94%	3.87%	1.95%	3.41%		
Net actuarial gain/(loss) & prior service (co	0.00%	0.00%	0.00%	0.00%	-7.98%	-1.60%	-3.99%		
Other comprehensive (loss) from discont opers	0.00%	-0.02%	0.00%	0.00%	0.00%	0.00%	0.00%		
Accumulated other comprehensive income (loss)	-3.19%	-2.54%	-2.72%	0.40%	-4.10%	-2.43%	-1.85%		
Total stockholders' equity	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%		

Statement of Cash Flow Analysis

We began the forecasting process by common sizing the cash flow statement to see if there were any patterns. We noticed net income had a consistent trend unlike the rest of the numbers within the statement. We proceeded by manipulating the following ratios: CFFO/NI, CFFO/OI, CFFO/Sales, and CFFO/Gross Profit. After looking to find patterns in the numbers, we opted to forecast using the CFFO/NI and CFFO/Sales. We forecasted CFFO by using the previously forecasted sales numbers from the income statement. Then we continued by using the forecasted cash flows to calculate net income with the CFFO/NI ratio. After looking at the forecasted net income and operating cash flows, we recognized a trend between the previous cash flow statements. This perceived trend proved good logic in our justification. We forecasted the CFFI activities using our estimates of changes in PP&E. This proved to be a more effective measure of the growth of Total Assets because the Balance Sheet estimate contained misleading items like Capitalized Software and a poorly defined Other Assets section.

(numbers in millions)															
Statement of Cash Flows	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Net income (loss)	\$371	\$364	\$667	\$1,088	\$1,153	\$1,220	\$1,293	\$1,371	\$1,453	\$1,540	\$1,633	\$1,731	\$1,834	\$1,944	\$2,061
Loss (income) from discontinued operations	-	-	-	(\$111)	(\$19)										
Asset impair, PVOL & other unit closing costs	\$104	\$35	\$19	\$12	\$4										
Restructuring & other charges, net	-	-	-	-	-										
Depreciation & amortization	\$667	\$394	\$368	\$372	\$389										
Net gains on sale of assets	(\$18)	(\$51)	(\$8)	(\$27)	(\$8)										
Real estate (gain)	-	-	-	-	-										
Co contributions to savings & profits sharing	\$47	-	-	-	-										
Benefit plans expense (income)	\$30	\$135	\$45	\$49	(\$51)										
Pension contribution	(\$300)	(\$300)	(\$300)	-	(\$300)										
Stock-based compensation	\$4	\$9	\$23	\$38	\$60										
Tax benefits on stock options exercised	-	-	-	-	\$6										
Deferred stock compensation	-	-	-	-	-										
Deferred taxes	\$141	\$137	\$1	\$15	(\$6)										
Receivables	(\$6)	\$3	(\$34)	(\$44)	\$29										
Sale of drugstore receivables	-	-	-	-	-										
Other receivables	-	-	-	-	-										
Inventory	\$82	(\$100)	(\$13)	(\$67)	(\$190)										
Prepaid expenses & other assets	(\$36)	(\$36)	\$9	(\$16)	(\$37)										
Other assets	-	-	-	-	-										
Accounts payable	\$138	-	\$33	-	-										
Trade payables	-	-	-	\$28	\$195										
Accounts payable & accrued expenses	-	\$94	-	-	-										
Current income taxes payable	\$3	(\$17)	\$182	(\$124)	(\$1)										
Accrued expenses & other liabilities	-	-	\$135	\$124	\$31										
Other liabilities	\$102	\$145	-	-	-										
Net cash flows from operating activities	\$1,329	\$812	\$1,127	\$1,337	\$1,255	\$1,414	\$1,498	\$1,588	\$1,684	\$1,785	\$1,892	\$2,005	\$2,125	\$2,253	\$2,388
Cash Flows From Investments	(\$277)	(\$239)	\$4,302	(\$221)	(\$752)	(\$260)	(\$272)	(\$289)	(\$307)	(\$326)	(\$346)	(\$367)	(\$390)	(\$414)	(\$439)

Common Size Cash Flow Statement	2002	2003	2004	2005	2006	AVG	AVG 05-06
Net income (loss)	27.92%	44.83%	59.18%	81.38%	91.87%	61.04%	86.62%
Loss (income) from discontinued operations	0.00%	0.00%	0.00%	-8.30%	-1.51%	-4.91%	-4.91%
Asset impair, PVOL & other unit closing costs	7.83%	4.31%	1.69%	0.90%	0.32%	3.01%	0.61%
Restructuring & other charges, net	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Depreciation & amortization	50.19%	48.52%	32.65%	27.82%	31.00%	38.04%	29.41%
Net gains on sale of assets	-1.35%	-6.28%	-0.71%	-2.02%	-0.64%	-2.20%	-1.33%
Real estate (gain)	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Co contributions to savings & profits sharing	3.54%	0.00%	0.00%	0.00%	0.00%	0.71%	0.00%
Benefit plans expense (income)	2.26%	16.63%	3.99%	3.66%	-4.06%	4.50%	-0.20%
Pension contribution	-22.57%	-36.95%	-26.62%	0.00%	-23.90%	-22.01%	-11.95%
Stock-based compensation	0.30%	1.11%	2.04%	2.84%	4.78%	2.21%	3.81%
Tax benefits on stock options exercised	0.00%	0.00%	0.00%	0.00%	0.48%	0.10%	0.24%
Deferred stock compensation	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Deferred taxes	10.61%	16.87%	0.09%	1.12%	-0.48%	5.64%	0.32%
Receivables	-0.45%	0.37%	-3.02%	-3.29%	2.31%	-0.82%	-0.49%
Sale of drugstore receivables	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Other receivables	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Inventory	6.17%	-12.32%	-1.15%	-5.01%	-15.14%	-5.49%	-10.08%
Prepaid expenses & other assets	-2.71%	-4.43%	0.80%	-1.20%	-2.95%	-2.10%	-2.07%
Other assets	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Accounts payable	10.38%	0.00%	2.93%	0.00%	0.00%	2.66%	0.00%
Trade payables	0.00%	0.00%	0.00%	2.09%	15.54%	3.53%	8.82%
Accounts payable & accrued expenses	0.00%	11.58%	0.00%	0.00%	0.00%	2.32%	0.00%
Current income taxes payable	0.23%	-2.09%	16.15%	-9.27%	-0.08%	0.99%	-4.68%
Accrued expenses & other liabilities	0.00%	0.00%	11.98%	9.27%	2.47%	4.74%	5.87%
Other liabilities	7.67%	17.86%	0.00%	0.00%	0.00%	5.11%	0.00%
Net cash flows from operating activities	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

Conclusion

Overall, it appears that J. C. Penney's productivity is beginning to converge with that of the industry averages. Although the company took a "big bath" in 2004 with the selling of Eckerd therefore decreasing their asset base, they have begun to make a comeback. They are maintaining constant levels of growth while decreasing their total liabilities and increasing their equity. This gives us confidence in our future predictions and optimism that J. C. Penney will continue to grow and prosper within the next ten years.

The image shows the JCPenney logo, which consists of the letters "JCPenney" in a white, sans-serif font. The logo is centered on a large, solid pink rectangular background.

Analysis of Valuations

There are several valuation methods that can be used to derive the share price of a company. Some of these methods are more accurate than others because some are derived through theory while others are quick screening methods. The method of comparables helps us take a quick glance at the share price relative to the industry average. Based on this data, we can draw immediate conclusions as to whether our company is overvalued, fairly valued, or undervalued. The intrinsic valuation models, on the other hand, help us come up with a more reliable share price that can be used to more accurately value the firm. Using these valuations, we weighted the several methods from most accurate to least accurate to come up with a specific share price that we believe to show a more realistic picture.

Method of Comparables

	Price
Trailing P/E:	\$80.34
Forward P/E:	\$75.64
P.E.G.:	\$42.55
P/B:	\$39.62
P/EBITDA:	\$21.90
P/FCF:	N/A*
EV/EBITDA:	\$72.17

The method of comparables is a way to value a company by computing its share price based upon industry averages. It does so by comparing the firm's ratios with industry average ratios. We first took J. C. Penney's financial data used for these ratios and put them into a per share basis. We then did the same for its competitors. By calculating each ratio, we derived an industry average based on the ratios computed for Dillard's, Kohl's, Stein Mart, and Stage Stores,

Inc. We set these averages equal to our computed ratios for J. C. Penney to get a price per share based on each one. The following are the results of this process.

Forward Price to Earnings

	PPS	EPS	P/E	Industry Average	JCP Share Price
JCP	81.99	11.30	7.26	15.04	75.64
KSS	70.27	4.51	15.58		
DDS	34.62	1.84	18.82		
SSI	21.02	1.66	12.66		
SMRT	12.57	.96	13.09		

This method uses our computed forecasted earnings per share (EPS) and the current price per share (PPS) reported on June 1, 2007 to derive a P/E ratio for J.C. Penney. We then took each of our competitors listed prices per share and their projected earnings per share to get each of their P/E ratios as well. These numbers were taken from yahoo finance for simplicity purposes. An industry average was computed by taking the summation of each of our competitors P/E ratios and dividing that number by four (the number of competitors listed within our industry). After getting an industry average of 15.04, we multiplied it by J. C. Penney's forecasted EPS of 11.30 in order to come up with an estimated price per share for our company. This number was determined to be \$75.64. Based on this method, J. C. Penney appears to be slightly overvalued when comparing this number to our actual PPS of \$81.99. However, since J. C. Penney's P/E ratio is ultimately lower than the computed industry average P/E, this implies that the company still has room for future earnings growth.

Trailing Price to Earnings

	PPS	EPS	P/E	Industry Average	JCP Share Price
JCP	81.99	5.03	16.30	15.97	80.34
KSS	70.27	3.49	20.13		
DDS	34.62	2.81	12.32		
SSI	21.02	1.25	16.82		
SMRT	12.57	.86	14.62		

To get our company's and the industry average trailing P/E ratios, we took the same price per share provided by our company's most recent 10-K and the PPS reported as of June 1, 2007 for our competitors. However, the earnings per share used in this method were different than those we used in the forward P/E ratios. We used the current earnings per share instead. Using the same steps as the previous ratio, we derived an industry average by adding up all of our competitor's P/E ratios and dividing by four. We then multiplied this number, 15.97, by J. C. Penney's EPS of 5.03. We came up with a share price of \$80.34 for J. C. Penney. When compared to our current PPS of \$81.99, this method determines that J. C. Penney is fairly valued. In addition, since J. C. Penney's P/E ratio is about even with the industry average P/E, it seems as if the company has converged with the industry where earnings growth is concerned.

Price to Book

	PPS	BPS	P/B	Industry Average	JCP Share Price
JCP	81.99	18.99	4.32	2.09	39.62
KSS	70.27	18.32	3.84		
DDS	34.62	32.76	1.06		
SSI	21.02	13.19	1.59		
SMRT	12.57	6.76	1.86		

The price to book method of comparables uses the current price per share and book value of equity per share reported in our most recent annual report. We derived a P/B ratio for our company by dividing our PPS by our BPS. J. C. Penney's P/B ratio is 4.32. We then took the same PPS and the BPS of our competitors reported on yahoo finance for June 1, 2007. We got an industry average of 2.09 and multiplied this number by our company's BPS of 18.99. This gave us a share price for J. C. Penney of \$39.62. When compared to our current PPS of \$81.99, J. C. Penney is overvalued using this method. With the P/B ratio of our company being higher than the industry average, this also shows that J. C. Penney is overvalued.

Dividend Yield

	PPS	DPS	D/P	Industry Average	JCP Price per Share
JCP	81.99	.72	.009	.05	14.44
KSS	70.27	N/A	N/A		
DDS	34.62	.16	.005		
SSI	21.02	.12	.006		
SMRT	12.57	1.75	.139		

The dividend yield method uses the current price per share and divides it by the dividends per share to get a number for dividends paid in comparison to a company's share price. We did this for J. C. Penney and its competitors. Kohl's was the only company not included in this method because they do not pay out dividends. We derived an industry average of .05 by adding up all of our competitor's D/P ratios and dividing by three so as to not include Kohl's in our estimations. Then we took this industry average and divided it into J. C. Penney's DPS to get a share price of \$14.44 for the company. This method shows that J. C. Penney is extremely overvalued with regard to their current share price. But since there is a high degree of noise in the market when calculating dividend yields, this number is not a very good indicator of the value of the firm.

Price Earnings Growth

	PPS	EPS	PEG	Industry Average	JCP Price per Share
JCP	81.99	5.03	2.72	1.41	42.55
KSS	70.27	3.49	.93		
DDS	34.62	2.81	3.1		
SSI	21.02	1.25	.84		
SMRT	12.57	.86	.78		

The price earnings growth model uses a company's P/E ratio and divides it by its estimated earnings growth rate. To derive a share price for J. C. Penney, we took an average of our competitor's PEG ratios, 1.41, and multiplied that number by our company's estimated earnings growth rate of 6 percent. We then multiplied the result by our EPS. We got a share price of \$42.55 for J. C. Penney. Compared to J. C. Penney's current price per share, we see that the company is overvalued once again.

Price to EBITDA

	PPS	EBITDA (in Billions)	P/EBITDA	Industry Average	JCP Price per Share
JCP	81.99	2.311	3.55	9.47	21.90
KSS	70.27	2.320	3.03		
DDS	34.62	.625	5.54		
SSI	21.02	.145	14.53		
SMRT	12.57	.090	14.02		

This method uses current share prices and earnings before interest, taxes, depreciation, and amortization to get a P/EBITDA ratio. We used the share price

and EBITDA reported on J. C. Penney's 2006 10-K. By using yahoo finance, we also came up with our competitor's PPS and EBITDA. To get reasonable numbers, we had to place all of the EBITDAs in decimals according to billions. By dividing the PPS by the EBITDA for each company, we came up with each individual P/EBITDA ratio. We then computed an industry average by taking the sum of the P/EBITDA ratios for J. C. Penney's competitors and dividing this number by four. We got an industry average of 9.47. Then we took that number and multiplied it by J. C. Penney's EBITDA to get a share price for our company of \$21.90. This number indicates that J. C. Penney is extremely overvalued when compared to our reported price per share.

Enterprise Value to EBITDA

	EV	EBITDA (in Billions)	EV/EBITDA	Industry Average	JCP Price per Share
JCP	19.29	2.311	8.34	7.39	72.17
KSS	25.20	2.320	10.86		
DDS	3.95	.625	6.32		
SSI	.92	.145	6.36		
SMRT	.54	.090	6.02		

A company's enterprise value is its price per share plus its book value of liabilities minus its cash and cash equivalents. We computed this number for J. C. Penney to be 19.29. To calculate J. C. Penney's price per share using this method, we first derived an industry average of EV/EBITDA. This number was determined by using the enterprise values of J. C. Penney's competitors and dividing them by their respective EBITDA. These numbers were reported on June 1, 2007 by yahoo finance. We took that total and divided by four to get the average. When deriving a share price we had to multiply the industry average

by J. C. Penney's EBITDA. Then we subtracted its book value of liabilities, \$3,444, and added its cash, \$3,689. These numbers were provided by the company's most recent balance sheet. We came up with \$16,310.42. By dividing this number by the total number of shares for J. C. Penney, we determined that our company's share price based on this model is \$72.17. Again, when compared to the current share price of \$81.99, this company is overvalued.

Price to Free Cash Flows

To determine the P/FCF ratio, free cash flows must first be computed. This is simply the summation of cash flow from operations and cash flow from investing. We would use the same methodology as we did for the other ratios, trying to derive a share price for our company. However, this ratio is not effective because J. C. Penney has negative cash flows at this time. We decided that this ratio would be irrelevant for the determination of share price based on this information.

Conclusion

It is obvious that by using these methods, J. C. Penney is an overvalued company. Every share price that we have calculated has been lower than the industry average with the exception of our trailing P/E ratio. Valuing a company based on the method of comparables is questionable to say the least. These methods use information in a way that suggests that these companies are operated in exactly the same way. In addition, things like their size, capital structure, and accounting methods are not taken into consideration when comparing these companies using these methods. Even though these methods have been acceptable for some time now, we feel that in order to value a firm properly there must be other methods available. Intrinsic valuations are methods used that take into account the future possibilities of a firm's activity. These methods are discussed in the next sections.

Cost of Equity

The cost of equity, K_e , is an estimation of our expected return on stock or securities for the current year. We used the CAPM model to calculate a reasonable approximation of J. C. Penney's cost of equity. In order to do this we had to gather the necessary values to compute the CAPM model, which consist of the risk-free rate, our company's beta, and the expected market return. Before we could place all of our results into the equation, we had to run a regression analysis to calculate our firm's beta. Using the St. Louis Federal Reserve website, we were able to find the past Treasury bill rates, which gave a logical estimate of our risk-free and market return rates.

After running several regressions over different periods using the 72, 60, 48, 36, and 24 months, our results varied across the board. Looking at all periods we covered the 3-month, 6-month, 2 year, 5 year, and 10 year T-bill rates. We found the 3-month gave us the best results. We came to this conclusion because this period had the highest R^2 of 19.13 percent, which represents the level of explainable movement based on the benchmark index. This inherently led to our beta being calculated at 1.1306, with a risk-free rate of 4.87 percent. Using the documented returns from the S&P 500 over the past 17 years, we found a long-run average to be 12.6 percent. We used the long-run return in order to take into effect all fluctuations of the market, and determined it to be the best for our estimations. Using the CAPM model, we were able to insert our findings and calculate our K_e to be 8.41 percent.

Regression Analysis

3 Month Rate	72 months	60 months	48 months	36 months	24 months
RF	4.87%	4.87%	4.87%	4.87%	4.87%
R ²	0.1906	0.1913	0.0260	0.0107	0.0348
Beta	1.1599	1.1306	0.6610	0.6224	0.8683
K _e	8.50%	8.41%	6.94%	6.82%	7.59%

6 Month Rate	72 months	60 months	48 months	36 months	24 months
RF	4.93%	4.93%	4.93%	4.93%	4.93%
R ²	0.1907	0.1911	0.0261	0.0106	0.0351
Beta	1.1604	1.1302	0.6610	0.6215	0.8691
K _e	8.49%	8.40%	6.96%	6.84%	7.60%

2 Year Rate	72 months	60 months	48 months	36 months	24 months
RF	4.77%	4.77%	4.77%	4.77%	4.77%
R ²	0.1899	0.1895	0.0247	0.0100	0.0351
Beta	1.1575	1.1252	0.6509	0.6157	0.8697
K _e	8.51%	8.40%	6.87%	6.76%	7.58%

5 Year Rate	72 months	60 months	48 months	36 months	24 months
RF	4.67%	4.67%	4.67%	4.67%	4.67%
R ²	0.1894	0.1886	0.0227	0.0096	0.0351
Beta	1.1547	1.1215	0.6383	0.6118	0.8692
K _e	8.52%	8.40%	6.80%	6.71%	7.56%

10 Year Rate	72 months	60 months	48 months	36 months	24 months
RF	4.75%	4.75%	4.75%	4.75%	4.75%
R ²	0.1893	0.1883	0.0215	0.0095	0.0353
Beta	1.1539	1.1203	0.6310	0.6107	0.8704
K _e	8.50%	8.39%	6.80%	6.73%	7.58%

Cost of Debt

J. C. Penney's cost of debt on a before-tax basis was 6.22 percent. Their cost of debt after-tax was 4.04 percent. In order to get these numbers we used a three-month non-financial commercial paper rate of 5.19 percent. Then we applied this percentage to trades payable and accrued expenses and other current liabilities. We used a two-year non-financial risk-free government rate of 4.87 percent for deferred taxes. These numbers were found by using FRED on the St. Louis Federal Reserve website. We used the pension rate of 5.8 percent

provided in the 10-K and applied this to other liabilities. We did so because pensions were the main expense that the company paid and characterized as other liabilities. A corporate tax rate of 35 percent was provided within the company's 2006 10-K.

The interest rate for the company's long-term debt was 7.69 percent. We calculated this number by taking every item listed under long-term debt within the company's annual 10-K. Each was provided with a rate, and a weight for each one was calculated by making each one a percentage of total long-term debt. We then multiplied the rate by the estimated weight to get the value ranked weight for each line item.

In order to get the cost of debt estimations we took all the liability amounts listed in the annual 10-K and set them all as percentages of total liabilities. We then multiplied those percentages by the interest rates we derived in the above paragraphs. This gave us a value added weight for each line item under total liabilities. We took the sum of all of these value added weights to get the before tax cost of debt. By multiplying this number by 1 minus the corporate tax rate, we derived the after tax weighted average cost of debt.

Weighted Average Cost of Capital

After getting the cost of equity and cost of debt, we plugged them into the WACC formula with a K_e of 13.61 percent. This number was calculated using CAPM with the provided risk-free rates located in the 10-K, the S&P 500 average market return, and the beta we derived from our regression analysis. The before tax weighted average cost of capital was 8.72 percent and the after tax cost of capital was 7.28 percent (by using 1 minus the tax rate).

Intrinsic Valuations

Intrinsic valuations give a better overall picture of the firm as a group compared to the comparable methods. The reason is that the four intrinsic methods used to value J. C. Penney slice and dice the company, looking at many different angles of valuation. The methods used were the discounted dividend model, the free cash flows model, residual income model, and the long run ROE residual income model. Following is a discussion of each of the models and their relevance in valuing the J. C. Penney Company.

Discount Dividends Model

The discount dividends model values a firm by the value it holds for its shareholders. Shareholders consider receiving value from a firm they invest in by the dividends they receive. Therefore, this method consists of discounting the future dividends back to present value to value the firm. This method is not very reliable due to several factors. First, we must assume the profitability of a company to go on for an indefinite period whereas in real life it could go bankrupt. In addition, dividends generally increase in a stepladder fashion. This means that dividends remain at the same level for some time and then they “step” into a higher value for some time and so forth. This has a very small volatility measure, therefore not showing the volatility that is within the pricing of a firm from day to day. This just shows it’s a very inaccurate way to value a firm. Following is the model in respect for J. C. Penney.

Sensitivity Analysis

Growth Rates

		0.105	0.11	0.114	0.115	0.1175
K _e	0.118	\$25.91	\$41.34	\$77.77	\$102.06	\$587.81
	0.12	\$23.08	\$34.05	\$50.71	\$63.20	\$121.49
	0.1361	\$13.53	\$16.06	\$18.08	\$18.71	\$20.57
	0.15	\$11.36	\$12.17	\$12.98	\$13.21	\$13.85
	0.16	\$10.18	\$10.71	\$11.22	\$11.36	\$11.74



Over Valued <\$69.69

Fairly Valued within 15%

Under-valued >\$94.24

Actual PPS (as of June 1, 2007)- \$81.99

To calculate the value of J. C. Penney using this valuation model, we first looked at our dividends. We took an average of the change in dividends, took out some outliers, and saw a consistent increase of 11 percent about every three years. We believe J. C. Penney will continue to increase their dividends in this fashion due to the consistent profitability they have had the last couple of years. We then discounted these dividends back to present value and found the sum. Once we added up the dividends for the next ten years, we used the perpetuity equation to value the firm for the indefinite amount of time past ten years. This is valued by using a selected dividend amount divided by cost of equity minus growth of dividends. We decided not to grow dividends anymore since in the past they had kept a dividend amount for more than 3 years. Since we were so aggressive in our growth for the next ten years, we assumed they would maintain the dividend amount at about a dollar for a long period of time. Therefore, we kept the 99 cents we had for the last four years. This perpetuity came out to be \$37.93 in year ten value. So we then discounted back to the present value of \$10.59. We added the value of the firm for the next ten years with the value of the perpetuity and came up with the value of our company.

The total value of our firm as of January 2007 came out to be \$15.53 per share. Since we are valuing our firm as of June 1, 2007, we then had to grow our share price to June 1 and the new implied share price is \$16.06. This amount is a lot smaller than the amount of J. C. Penney's share price in the market of \$81.99. This shows that our company is overvalued by a large

amount in the eye's of shareholders due to the small dividends that are paid out. If one were to divide the present value of the sum of the dividends for the next ten years and the perpetuity dividend present value by the total value of the firm, one can notice that about 70 percent of the value of our firm comes from the perpetuity. This proves how inaccurate this model can be because we are relying heavily on a perpetuity that is full of assumptions.

Within our sensitivity analysis, we observed that the only way J. C. Penney was fairly valued was by cutting cost of equity to 11.8 percent and having a dividend growth rate of 11.4 percent. We believe that J. C. Penney could not cut their cost of equity all the way to only 11.8 percent from their actual 13.61 percent at the moment. J. C. Penney could be undervalued if the cost of equity was cut down to 12 percent or lower and needed to grow dividends at least at 11.5 percent. We do not believe J. C. Penney could cut the cost of equity that much or grow dividends at these rates because besides some outliers it has never followed this pattern in the past. Even though the discount model does not show a clear understanding of our firm due to the low dividend payments, it illustrates that J. C. Penney is overvalued due to its high share price of \$81.99.

Free Cash Flows Model

The free cash flow model compares the cost of capital to growth rate on the perpetuity. The percentage of the both present value of future cash flows and terminal value perpetuity are almost equally weighted in the valuation of the firm. For this reason, this model is seen as a fairly inaccurate model. Even though cash flows make up about 58 percent of the value, 42 percent is still a large weight to have on a number so sensitive to growth rates. Following is the sensitivity analysis and discussion of the free cash flows model applied to the J. C. Penney Company.

Sensitivity Analysis

Growth Rates

		0.04	0.05	0.059	0.065	0.07
WACC BT	0.07	\$43.89	\$61.24	\$103.84	\$217.45	n/a
	0.08	\$30.54	\$38.44	\$ 52.00	\$ 70.07	\$101.70
	0.0872	\$24.03	\$29.09	\$ 36.70	\$ 45.21	\$ 56.84
	0.1	\$15.74	\$18.38	\$ 21.84	\$ 25.15	\$ 28.91
	0.11	\$10.99	\$12.70	\$ 14.83	\$ 16.71	\$ 18.72

	Undervalued <\$69.69
	Fairly Valued
	Overvalued >\$94.29

Actual PPS (June 1, 2007): \$81.99

The free cash flows model requires the following information: forecasted earnings, dividends, cash flows from operations and investments, the before tax weighted average cost of capital, book value of equity, and growth rate of the perpetuity.

To begin, the difference in operating cash flows and investing cash flows gives the annual free cash flow. Because we are looking at year now, all of these cash flows had to be brought back by multiplying them by the present value factor. The sum of all of these cash flows, \$9,504 million, plus the present value of the perpetuity, \$6,747 million, gave us the value of the firm, \$16,251 million. This value minus the book value of liabilities leads to the market value of equity divided by the number of shares outstanding to reach the estimated price per share.

$$\$16,251 - 8,385 = \$7,866$$

$$\$7,866 / 266 = \$34.80$$

Because J. C. Penney's fiscal year ends on January 31, this price per share was not in fact the price used to value our sensitivity analysis. To bring this number to June 1, 2007, the date of firm valuation, this share price was multiplied by the weighted average cost of capital raised to five months divided by twelve months.

$$\$34.80 * 1.0872^{(5/12)} = \$36.70$$

This particular stock price in our sensitivity analysis used a WACC of 8.72 percent and a growth rate of 5.9 percent. From here, we can begin to draw conclusions and form a sensitivity analysis.

The free cash flows model shows us, like many of our other models, that the firm is overvalued at June 1, 2007. Most of our conclusions draw on the fact the firm is overvalued. The few that fell into the firm being fairly valued, +/- 15 percent, required a weighted average cost of capital of 8 percent and growth rates ranging from 5.9 to 6.5 percent. Once again, this model relays that J. C. Penney is an overvalued firm.

Residual Income Model

Of all the intrinsic valuation models, this is said to be the most accurate. This is explained by the very high percentage of the present value of residual income in the overall value of the firm. Because this number is based off of forecasted values of earnings rather than perpetuities, this model is a fairly accurate glance at the firm. Following is the sensitivity analysis and discussion of the residual income model in respect to J. C. Penney.

Sensitivity Analysis

Growth Rate

		0	-0.15	-0.25	-0.4	-0.5
K _e	0.05	127.8	78.08	72.55	68.87	67.53
	0.07	79.18	60.3	57.55	55.62	54.98
	0.09	53.73	47.22	46.07	45.22	44.9
	0.11	38.62	37.45	37.21	37.02	36.95
	0.1361	26.61	28.15	28.52	28.81	28.93

	Undervalued <\$69.69
	Fairly Valued
	Overvalued >\$94.29

Actual PPS (June 1, 2007): \$81.99

To reach the values used in the sensitivity analysis, similar methods were used to reach the implied share price as on previous models. Actual earnings were found from the difference in operating and investing cash flows each year. To find “benchmark” earnings, the book value of equity from the prior year is multiplied by the cost of equity. The residual income, or the added or destroyed value of the firm, is the difference between these values, the actual earnings, and benchmark earnings.

The residual income is a key factor in this model. At first, we used the same forecasted residual income for the computation of our perpetuity; however, this was a mistake we corrected to find values that are more accurate in our sensitivity analysis. The trend across the years changes each time the cost of equity is changed due to the computation of benchmark earnings. All K_e , with the exception of our calculated cost of equity, required a positive forecast of residual income.

After computing the residual income across the board, they were all brought back to year now by multiplying by each year's present value factor. This number that we looked at, the present value of residual income, shows how the firm adds value to existing value. Following is a chart showing J. C. Penney's trend of present value of residual income.

	0	1	2	3	4	5	6	7	8	9	10
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
PV of Annual Residual Income		601	473	363	270	191	125	68	22	-17	-49

As a company grows with time, the residual income should converge with zero eventually. This is because no company can sustain high residual income for long without eventually coming together with the market. The chart above shows exactly this. As we move from now to 8 years into the future, we eventually get close to convergence with zero. Because the inaccurate nature of forecasting, it is hard to tell if J. C. Penney will in fact go into the negative with

residual income or converge. Future re-evaluation will be necessary to confirm this or justify the company destroying value.

The residual income model is said to be one of the best of the four models in explaining what is happening with the market price of stock. As we look at the model, again we see that the firm is consistently overvalued in share price. These figures show that the firm's calculated cost of equity consistently shows across the board a very low price. To get anywhere close to the price at June 1, 2007, the grow rate would either have to be ridiculously high, or the firm would have to have an unrealistically low cost of equity. Either way, the numbers would not make sense for the values that were calculated in this table. Once again, the conclusion drawn from researching the residual income model is that our firm, J. C. Penney, is overvalued.

The logo for JCPenney, featuring the text "JCPenney" in a white, sans-serif font. The "J" and "C" are smaller and positioned to the left of "Penney". The logo is set against a light pink rectangular background.

Long Run Return on Equity Residual Income Model

The long run return on equity residual income model calculates the value of the firm by using a perpetuity equation that can be derived from the methods of the residual income model. Although it is a perpetuity, it is a very accurate model due to the key factors that are used to value the firm within this particular model. It links the cost of equity, long run return on equity, and long run growth on equity. Following is the model in respect to the J. C. Penney Company.

Growth = .11

		ROE				
		0.13	0.15	0.17	0.19	0.21
K_e	0.125	\$26.68	\$53.36	\$80.04	\$106.72	\$133.40
	0.13	\$20.01	\$40.02	\$60.03	\$80.04	\$100.05
	0.1361	\$15.33	\$30.67	\$46.00	\$61.33	\$76.66
	0.14	\$13.34	\$26.68	\$40.02	\$53.36	\$66.70
	0.145	\$10.84	\$22.87	\$34.30	\$45.74	\$57.17

ROE = .13

		Growth Rate				
		0.09	0.1	0.11	0.12	0.13
K_e	0.125	\$22.87	\$24.01	\$26.68	\$40.02	\$0.00
	0.13	\$20.01	\$20.01	\$20.01	\$20.01	n/a
	0.1361	\$17.36	\$15.77	\$15.33	\$12.43	\$0.00
	0.14	\$16.01	\$15.01	\$13.34	\$10.00	\$0.00
	0.145	\$14.55	\$13.34	\$11.43	\$8.00	\$0.00

K_e = .1361

		Growth Rate				
		0.09	0.1	0.11	0.12	0.13
ROE	0.21	\$52.09	\$60.97	\$76.66	\$111.85	\$262.42
	0.19	\$43.40	\$49.89	\$61.33	\$87.00	\$196.81
	0.17	\$34.72	\$38.80	\$46.00	\$62.14	\$131.21
	0.15	\$26.04	\$27.71	\$30.67	\$37.28	\$65.60
	0.13	\$17.36	\$16.63	\$15.33	\$12.43	\$0.00

	Over Valued <\$69.69	
	Fairly Valued within 15% of \$81.99	
	Under-valued >\$94.24	Actual PPS (as of June 1, 2007)- \$81.99

To find our long run return on equity, we found the ROE for the next ten years using our forecasted earnings and book value of equity. The book value of equity had not been forecasted but it is very simple to find by using the following equation:

$$\text{Ending BVE} = \text{Beginning BVE} + \text{Earnings} - \text{Dividends}$$

Once this was done we used the return on equity equation of:

$$\text{ROE} = \text{Net Income (Earnings) of this year} / \text{BVE of previous year}$$

ROE	29.52%	24.97%	21.77%	19.39%	17.60%	16.17%	15.00%	14.06%	13.26%	12.57%
-----	--------	--------	--------	--------	--------	--------	--------	--------	--------	--------

We got the results above that helped us see the pattern of J. C. Penney's return on equity for the next ten years so we could make some assumptions of the long run return on equity. J. C. Penney's return on equity has a trend of decreasing until it hits a plateau at around 12 percent.

We then needed to find the long-run growth of return on equity. We calculated the percentage change of book value of equity in order to see the long run trend. This percentage change was calculated by taking this year's book value of equity divided by the previous years book value of equity then subtracted that amount by one.

BVE % Growth	25.30%	21.61%	19.00%	16.80%	15.38%	14.24%	13.13%	12.40%	11.78%	11.25%
--------------	--------	--------	--------	--------	--------	--------	--------	--------	--------	--------

We got the results above that helped us see the decreasing growth pattern of J. C. Penney's book value of equity. We assumed that it has on average hit a plateau of about 11 percent.

Once we found both long-run return on equity and long-run growth of equity, we plugged these numbers into the following equation:

$$\text{Value of Firm} = \text{BVE} \left(1 + \frac{(\text{LR Return on Equity} - K_e)}{(K_e - \text{LR Growth of Equity})} \right)$$

We then divided by the amount of outstanding shares we have at the moment, 226, to get our individual price per share. Our price per share through this model came out to be about \$14.54 for January 2007. We then grew this number to June 2007 in the amount of \$15.33.

This amount definitely shows that J. C. Penney is overvalued. Within our sensitivity analysis, by manipulating the numbers, J. C. Penney was, for the most part, overvalued no matter if we increased growth of equity, return on equity, or cut cost of equity. The only way our firm could be fairly valued would be to grow our return on equity to about 21 percent which does not seem feasible since the trend shows that we are decreasing to smaller percentages. Overall, the sensitivity analysis helps confirm that our company is overvalued by this valuation method.

Abnormal Earnings Growth Model

Abnormal earnings growth model brings theory to the price earnings ratio. It links the capitalized forward earnings and the extra value created from abnormal earnings growth. The main difference between this model and the others is this one discounts back to year one instead of year zero and it keeps a constant perpetuity. This is a very accurate model and can be proven because it is linked directly to residual income. Following is the sensitivity analysis and discussion of the abnormal earnings growth model in respect to J. C. Penney.

Sensitivity Analysis

Growth Rates

		0	-0.15	-0.25	-0.4	-0.5
K_e	0.05	47.35	62.29	65.8	68.61	69.75
	0.07	33.82	44.49	47.00	49.01	49.82
	0.09	26.31	34.61	36.56	38.12	38.75
	0.11	21.52	28.31	29.91	31.19	31.70
	0.1361	17.40	22.88	24.17	25.21	25.62



Undervalued <\$69.69

Fairly Valued

Overvalued >\$94.29

Actual PPS (June 1, 2007): \$81.99

We first had to calculate the cumulative dividend income by adding forecasted earnings to our drip income. Drip income is found by multiplying the previous year's dividend by our cost of equity. Once the cumulative dividend income is found, we needed to calculate the normal income, "benchmark", by taking the previous year's earnings times one plus J. C. Penney's cost of equity which is 13.61 percent. To find the annual AEG, which links our residual income model to our AEG model, we take the cumulative dividend income minus the calculated benchmark. We then had to bring back these values to year one by multiplying by the present value factor. The present value factor is calculated by taking one divided by one plus the cost of equity to the previous time period. Once the present values of our annual AEG components were found, we added all of these together to get the total present value of the abnormal earnings growth, -453.20.

We then had to find the value of the perpetuity to account for the years out to infinity. To do this, we forecasted an abnormal earnings growth for year eleven that followed our pattern of abnormal earnings growth. This value came to be -131 million. We then plugged it into the perpetuity equation:

$$\text{AEG Perpetuity} = \text{forecasted AEG} / (\text{JCP } K_e - \text{growth})$$

This value of the perpetuity then needed to be brought back to year one from year ten. We did this by multiplying by the present value factor of year ten. We then summed the core earnings, which are the forecasted earnings in 2007, plus the perpetuity present value and the sum of the present value of abnormal earnings growth. To find our value of equity, we took this sum and divided by the J. C. Penney's cost of equity. Finally, we took our number of shares outstanding at present time and divided it into our value of equity to come up with our estimated price per share of \$22.88 adjusted to June 1, 2007.

During our sensitivity analysis, we used aggressive negative growth rates to attempt to reach our current share price. We were only successful in reaching a fairly valued share price by cutting cost of equity to .05 and having a growth rate of -50 percent. This proves along with our other models that J. C. Penney is extremely overvalued since we couldn't achieve a fairly valued price because we do not believe J. C. Penney could cut cost of equity to .05 and growth of -50 percent is not achievable.

Abnormal Earnings Growth and Residual Income Proof

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Annual AEG	-71.72	-77.50	-83.63	-87.29	-94.18	-101.47	-106.12	-114.32	-123.01
Change in RI	-71.72	-77.50	-83.63	-87.29	-94.18	-101.47	-106.12	-114.32	-123.01

As mentioned previously, the abnormal earnings growth and residual income models are linked. If one were to take the change in residual income from 2008 to 2007, the result would be the annual abnormal earnings growth from 2008. The chart above illustrates this for our forecasted years up to 2016. This can help verify that the valuation models are correctly calculated.

Because of this link, the abnormal earnings growth and residual income valuation share price should be very close. Our models came up with prices that were about nine dollars apart. After reviewing our numbers, we looked carefully at the perpetuity and realized that was where our numbers differed. The reason

for this large difference between share prices is that our residual income perpetuity had no variation after 2011. Tying this back to what was mentioned above, the change in residual income should equal the annual abnormal earnings growth. Since our residual income is a fixed number, the abnormal earnings growth after 2011 would be zero if we followed that rule. This is a limitation because of the nature of the perpetuity and it is not likely that our abnormal earnings growth would become zero.

This large difference between the two valuation share prices will become smaller as the perpetuity goes on to infinity. We set up our sensitivity analysis cost of equity and growth rates the same to be able to compare. We used aggressive growth rates all the way up to -50 percent to attempt to reach a small difference between the two prices. We were able to close the gap to about three dollars. Overall, this proves that the share price valuations are closely related besides limitations within the perpetuities.

Conclusion

After looking at all theoretical valuation models, we believe that J. C. Penney is overvalued at its June 1, 2007 share price of \$81.99. Even though the dividend model shows the company as overvalued, we have determined that this particular model is irrelevant in the case of our company due to the fact that the share price moved as low as \$10.18 and as high as \$587.81. The drastic fluctuations in share price were a definite indicator that the model is not useful in our case. The J. C. Penney Company, according to all of the sensitivity analysis' conclusions, is overvalued anywhere from \$40.00-\$55.00 at June 1, 2007.

Credit Analysis

We evaluated J. C. Penney's credit worthiness using the Altman Z-score model, which weights five variables to compute a bankruptcy score (Palepu). The Altman Z-score predicts bankruptcy when the score is lower than 1.81. Firms with a score between 1.81 and 2.67 are considered to be borderline. Firms are considered to be healthy and to have a low risk of bankruptcy if they score above a 3. "This is a relatively accurate model -- real world application of the Z-Score successfully predicted 72 percent of corporate bankruptcies two years prior to these companies filing for Chapter 7" (www.investopedia.com). The only problem with this model is that it favors mature companies or established companies over new start up companies because new start ups do not possess a financial history upon which to base a score.

The Altman Z-score is calculated using the following formula:

$$\text{Z-Score} = 1.2(\text{Working Capital}/\text{Total Assets}) + 1.4(\text{Retained Earnings}/\text{Total Assets}) + 3.3(\text{Earnings before Interest and Taxes}/\text{Total Assets}) + .6(\text{Market Value of Equity}/\text{Book Value of Debt}) + 1.0(\text{Sales}/\text{Total Assets})$$

Altman Z-score

	2002	2003	2004	2005	2006
Z-score	2.75	1.91	3.04	3.43	3.80

According to the Altman Z-score model, J. C. Penney's current Z-score is 3.80; however, in 2003, J. C. Penney was borderline bankruptcy according to the model. This was caused by the discontinuation of operations of its subsidiaries, Eckerd Pharmacy and Rojas Renner S.A. Since the sale of Eckerd Pharmacy and Rojas Renner S.A., J. C. Penney's score has steadily risen from 3.04 to 3.80.

Analyst Recommendation

After careful consideration and research of the J.C. Penny Company, including an industry analysis, accounting analysis, financial analysis, forecasting and future financial statements, and valuation model conclusions, we consider the firm to be highly overvalued and should be set to sell.

Assumptions used to calculate all relevant information were taken considering past financials of the company as well as four other competitors, Stein Mart, Kohl's, Dillard's, and Stage Stores, Inc. This department retail industry is very highly concentrated with relevant competition set as those who take advantage of similar key success factors such as economies of scale and scope, supplier relationships, and brand creation within different stores.

Looking at accounting ratios, J. C. Penney held the standard of the industry and even surpassed many competitors in respect to sales being supported by business happenings. There were no problems found or any indication that financial statements have been manipulated to reflect better numbers in the last five years of the business. Appropriate values were reflected in the years where J. C. Penney sold unprofitable assets, and again reveal the turnaround after the fact. If anything, disclosure has only improved year by year, making the company fairly easy to value. As for financial ratios, we deemed that J.C. Penney overall had a superior performance over the market.

When forecasting the financial statements of the company, not only were trends of the past five years of the company used, but also that of the competitors. We feel the growth percentage used was fairly chosen, if not a little conservative in estimation, and gives an accurate look into the future.

Even though no real problems were found and the company seems to fly above the competition on many aspects, the valuation models used based off of these future forecasts show that the company is overvalued. Even after deeming

the discount dividend model irrelevant to our company, all other models consistently showed an overall picture of overvaluations.

After consideration of all aspects, we recommend that the stock of J. C. Penney be set to sell. Throughout this analysis, company stock prices were compared to the price at June 1, 2007, \$81.99. We feel that our valuations are correct seeing that the price on June 22, 2007 is at \$72.98. The market has obviously realized what we have found, that the company is overvalued. We also see an opportunity to buy put options on the stock. If we are on target, buying a put option for next month would give the market a little more time to continue to realize this, giving investors the chance to cash in on the overvaluation.

The image shows the JCPenney logo in white text on a light pink background. The logo consists of the letters 'JCPenney' in a sans-serif font, with a small registered trademark symbol (®) at the end of 'Penney'.

Appendix

Liquidity Ratios

Current ratio

	2002	2003	2004	2005	2006
JCP	2.008	1.735	2.445	2.427	1.904
KSS	2.178	2.695	2.502	2.443	1.773
DDS	3.531	2.263	2.194	1.874	2.096
SSI	3.610	2.737	2.572	2.434	2.578
SMRT	1.855	2.553	2.190	2.386	2.033

Inventory Turnover

	2002	2003	2004	2005	2006
JCP	4.565	3.538	3.561	3.553	3.552
KSS	3.676	4.286	3.897	3.861	3.822
DDS	3.296	3.167	2.895	2.781	2.840
SSI	3.392	2.667	3.140	3.358	3.296
SMRT	6.215	8.473	6.032	6.116	6.411

Quick asset ratio

	2002	2003	2004	2005	2006
JCP	0.764	0.860	1.477	1.190	0.862
KSS	1.032	1.156	1.096	1.110	n/a
DDS	1.670	1.012	0.486	0.272	0.209
SSI	0.199	0.111	0.283	0.217	0.099
SMRT	0.087	0.135	0.555	0.782	0.228

Days supply of inventory

	2002	2003	2004	2005	2006
JCP	79.959	103.165	102.498	102.731	102.749
KSS	99.286	85.167	93.666	94.535	95.511
DDS	110.755	115.241	126.064	131.229	128.535
SSI	107.594	136.854	116.228	108.680	110.750
SMRT	58.732	43.080	60.507	59.679	56.937

Accounts receivable turnover

	2002	2003	2004	2005	2006
JCP	45.882	76.335	45.604	69.559	75.677
KSS	9.205	8.940	8.420	8.112	n/a
DDS	5.912	6.378	780.082	603.704	726.690
SSI	79.430	27.689	n/a	n/a	n/a
SMRT	286.369	320.666	249.420	133.227	147.707

Working capital turnover

	2002	2003	2004	2005	2006
JCP	7.713	6.447	3.700	4.767	6.306
KSS	5.135	5.405	5.349	5.319	10.486
DDS	3.526	4.503	6.031	7.537	7.132
SSI	3.201	4.217	5.524	6.041	6.111
SMRT	9.662	7.286	6.910	6.135	8.589

Days sales outstanding

	2002	2003	2004	2005	2006
JCP	7.955	4.782	8.004	5.247	4.823
KSS	39.653	40.829	43.349	44.993	n/a
DDS	61.737	57.231	0.468	0.605	0.502
SSI	4.595	13.182	n/a	n/a	n/a
SMRT	1.275	1.138	1.463	2.740	2.471

Profitability Ratios

Gross profit margin

	2002	2003	2004	2005	2006
JCP	-0.847	0.372	0.387	0.393	0.393
KSS	0.344	0.330	0.352	0.355	0.364
DDS	0.381	0.458	0.501	0.531	0.519
SSI	0.303	0.288	0.289	0.291	0.293
SMRT	0.247	0.251	0.266	0.281	0.277

Asset turnover

	2002	2003	2004	2005	2006
JCP	1.801	0.984	1.136	1.413	1.584
KSS	1.622	1.580	1.594	1.565	1.709
DDS	1.151	1.161	1.244	1.349	1.398
SSI	7.262	6.337	6.348	6.172	6.414
SMRT	3.403	3.375	3.365	2.980	3.002

Operating expense ratio

	2002	2003	2004	2005	2006
JCP	0.268	0.328	0.316	0.309	0.277
KSS	0.199	0.203	0.217	0.221	0.219
DDS	0.274	0.276	0.279	0.270	0.274
SSI	0.202	0.209	0.222	0.223	0.233
SMRT	0.232	0.255	0.234	0.238	0.251

Return on assets

	2002	2003	2004	2005	2006
JCP	0.022	-0.052	0.029	0.077	0.093
KSS	0.131	0.094	0.109	0.106	0.121
DDS	-0.056	0.001	0.018	0.021	0.045
SSI	0.102	0.083	0.075	0.076	0.067
SMRT	0.050	0.005	0.097	0.107	0.072

Operating profit margin

	2002	2003	2004	2005	2006
JCP	0.031	0.044	0.071	0.084	0.097
KSS	0.120	0.100	0.106	0.106	0.117
DDS	0.056	0.032	0.046	0.040	0.043
SSI	0.101	0.079	0.067	0.068	0.060
SMRT	0.026	0.006	0.042	0.053	0.039

Return on equity

	2002	2003	2004	2005	2006
JCP	0.066	-0.146	0.097	0.224	0.288
KSS	0.230	0.168	0.174	0.170	0.186
DDS	-0.149	0.004	0.053	0.052	0.105
SSI	0.160	0.134	0.109	0.116	0.110
SMRT	0.102	0.010	0.167	0.184	0.115

Net profit margin

	2002	2003	2004	2005	2006
JCP	0.013	-0.052	0.028	0.058	0.058
KSS	0.071	0.057	0.062	0.063	0.071
DDS	-0.050	0.001	0.016	0.016	0.032
SSI	0.062	0.057	0.041	0.042	0.036
SMRT	0.015	0.002	0.026	0.034	0.025

Capital Structure Ratio

Debt to equity ratio

	2002	2003	2004	2005	2006
JCP	1.805	2.373	1.909	2.110	1.955
KSS	0.798	0.607	0.607	0.537	0.614
DDS	4.070	3.747	2.705	2.516	1.947
SSI	0.293	0.394	0.427	0.458	0.444
SMRT	0.837	0.726	0.716	0.606	0.667

Times interest earned

	2002	2003	2004	2005	2006
JCP	15.961	-10.866	-4.893	-16.467	14.785
KSS	18.341	13.601	19.279	19.646	27.191
DDS	2.687	1.506	2.820	3.027	3.145
SSI	-49.590	-31.428	-33.051	-30.990	-18.518
SMRT	13.815	4.700	1567.923	undefined	undefined

Debt service margin

	2002	2003	2004	2005	2006
JCP	0.506	0.421	0.521	0.720	0.712
KSS	40.784	2.122	75.637	254.530	28.714
DDS	3.631	3.113	3.337	4.029	1.817
SSI	533.599	1487.495	347.491	815.438	745.473
SMRT	0.722	undefined	undefined	undefined	undefined

Method of Comparables

	PPS	EPS forecast	EPS	DPS	BPS	BV	EV	FCF
JCP	81.99	11.3	5.03	0.72	18.99	18.99	19.29	269.00
KSS	70.27	4.51	3.49	N/A	18.32		25.2	
DDS	34.62	1.84	2.81	0.16	32.76		3.95	
SSI	21.02	1.66	1.25	0.12	13.19		0.92	
SMRT	12.57	0.96	0.86	1.75	6.761		0.54	
Industry AVG								

	P/E (trailing)	P/E (forward)	P/B	D/P	P.E.G	EBITDA (in billions)	P/EBITDA	P/FCF	EV/EBITDA
JCP	16.30	7.26	4.32	0.009	2.72	2.311	3.55	N/A	8.34
KSS	20.13	15.58	3.84	N/A	0.93	2.320	3.03	84.82	10.86
DDS	12.32	18.82	1.06	0.005	3.1	0.625	5.54	N/A	6.32
SSI	16.82	12.66	1.59	0.006	0.84	0.145	14.53	N/A	6.36
SMRT	14.62	13.09	1.86	0.139	0.78	0.090	14.02	N/A	6.02
Industry AVG	15.97	15.04	2.09	0.05	1.413	0.795	9.47	84.82	7.390

Price Comparables	Trailing	Forward	
P/E	80.34	75.64	
P/B	39.62		
D/P	14.44		
PEG	42.55		
P/EBITDA	21.90		
EV/EBITDA	72.17		
P/FCF	N/A		

3 Month Regression 72 Months

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.449493363
R Square	0.202044283
Adjusted R Square	0.190644916
Standard Error	0.085209953
Observations	72

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.128690494	0.128690494	17.72416631	7.46639E-05
Residual	70	0.508251528	0.007260736		
Total	71	0.636942022			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.02395843	0.01004484	2.385148001	0.019783542	0.003924629	0.043992231	0.003924629	0.043992231
X Variable 1	1.159873034	0.275503768	4.210007875	7.46639E-05	0.610398101	1.709347967	0.610398101	1.709347967

SUMMARY OUTPUT

60 months

Regression Statistics	
Multiple R	0.452814378
R Square	0.205040861
Adjusted R Square	0.191334669
Standard Error	0.077782436
Observations	60

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.090507942	0.090507942	14.95972481	0.000280412
Residual	58	0.350906229	0.006050107		
Total	59	0.441414171			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.022531053	0.010099422	2.230925039	0.029567509	0.002314864	0.042747242	0.002314864	0.042747242
X Variable 1	1.13064286	0.292323441	3.867780346	0.000280412	0.545493922	1.715791798	0.545493922	1.715791798

SUMMARY OUTPUT

48 months

Regression Statistics	
Multiple R	0.216255217
R Square	0.046766319
Adjusted R Square	0.026043848
Standard Error	0.065958576
Observations	48

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.009818252	0.009818252	2.256792556	0.139863647
Residual	46	0.200124552	0.004350534		
Total	47	0.209942804			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.030542564	0.01011469	3.019624271	0.004120452	0.010182749	0.050902379	0.010182749	0.050902379
X Variable 1	0.660952169	0.439971162	1.502262479	0.139863647	-0.224663833	1.546568172	-0.224663833	1.546568172

SUMMARY OUTPUT

36 months

Regression Statistics	
Multiple R	0.197449946
R Square	0.038986481
Adjusted R Square	0.010721378
Standard Error	0.063995173
Observations	36

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.005648822	0.005648822	1.379315	0.248378338
Residual	34	0.139242994	0.004095382		
Total	35	0.144891816			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.023414247	0.011021408	2.124433335	0.040986238	0.001016051	0.045812443	0.001016051	0.045812443
X Variable 1	0.622418625	0.529969468	1.174442421	0.248378338	-0.454608911	1.699446162	-0.454608911	1.699446162

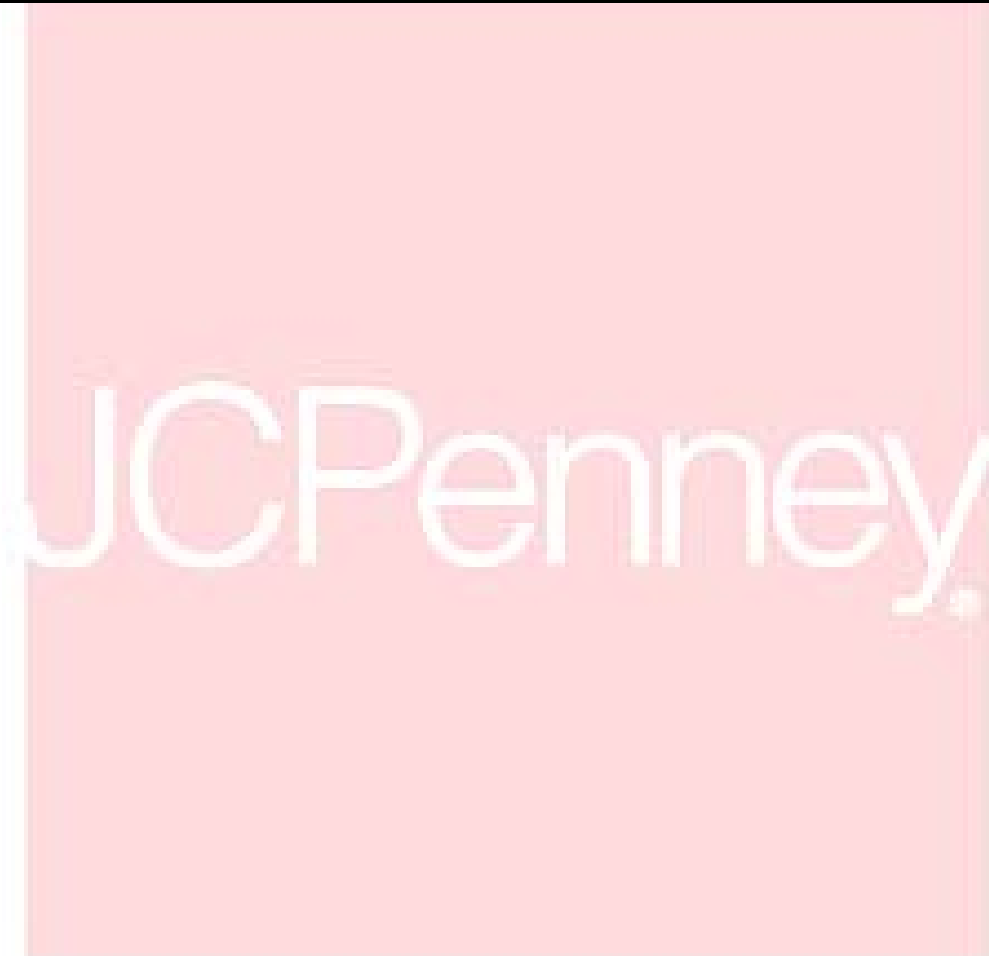
3 Month Regression
24 Months

SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.277145786
R Square	0.076809786
Adjusted R Square	0.034846595
Standard Error	0.058490786
Observations	24

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.006262143	0.006262143	1.830408596	0.189820587
Residual	22	0.075265784	0.003421172		
Total	23	0.081527927			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.018089978	0.012709597	1.423332134	0.168667626	-0.008268113	0.044448068	-0.008268113	0.044448068
X Variable 1	0.86829239	0.64178856	1.352925939	0.189820587	-0.462695614	2.199280393	-0.462695614	2.199280393



6 Month Regression

72 Month

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.44952832
R Square	0.20207571
Adjusted R Square	0.190676792
Standard Error	0.085208275
Observations	72

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.128710511	0.128710511	17.72762139	7.45559E-05
Residual	70	0.508231511	0.00726045		
Total	71	0.636942022			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.024086144	0.010043978	2.398068263	0.019151538	0.004054063	0.044118226	0.004054063	0.044118226
X Variable 1	1.160350997	0.275590438	4.210418197	7.45559E-05	0.610703206	1.709998788	0.610703206	1.709998788

SUMMARY OUTPUT

60 Month

Regression Statistics	
Multiple R	0.452575365
R Square	0.204824461
Adjusted R Square	0.191114538
Standard Error	0.077793022
Observations	60

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.09041242	0.09041242	14.93986943	0.000282764
Residual	58	0.351001752	0.006051754		
Total	59	0.441414171			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.022669716	0.010097087	2.24517387	0.028584318	0.002458201	0.042881232	0.002458201	0.042881232
X Variable 1	1.130202094	0.292403594	3.865212728	0.000282764	0.544892712	1.715511476	0.544892712	1.715511476

SUMMARY OUTPUT

48 Month

Regression Statistics	
Multiple R	0.216486835
R Square	0.04686655
Adjusted R Square	0.026146257
Standard Error	0.065955108
Observations	48

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.009839295	0.009839295	2.261867207	0.139429522
Residual	46	0.200103509	0.004350076		
Total	47	0.209942804			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.030639424	0.010091375	3.036199165	0.003936725	0.01032654	0.050952308	0.01032654	0.050952308
X Variable 1	0.66096566	0.439486303	1.503950533	0.139429522	-0.223674372	1.545605692	-0.223674372	1.545605692

SUMMARY OUTPUT

36 Month

Regression Statistics	
Multiple R	0.197246312
R Square	0.038906107
Adjusted R Square	0.01063864
Standard Error	0.063997849
Observations	36

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.005637177	0.005637177	1.376356322	0.248876419
Residual	34	0.139254639	0.004095725		
Total	35	0.144891816			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.023524249	0.010999319	2.138700426	0.03972785	0.001170943	0.045877555	0.001170943	0.045877555
X Variable 1	0.621523842	0.529776088	1.173182135	0.248876419	-0.455110698	1.698158383	-0.455110698	1.698158383

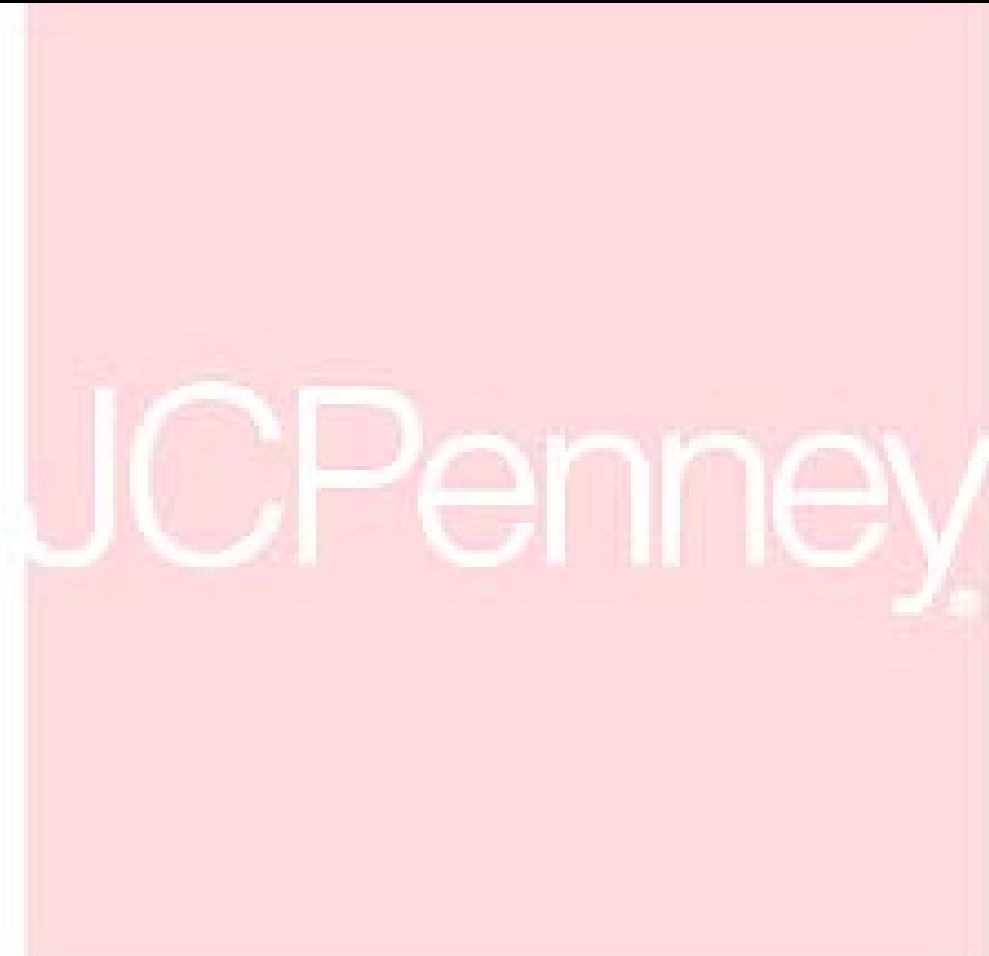
6 Month Regression
24 Month

SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.277563315
R Square	0.077041394
Adjusted R Square	0.03508873
Standard Error	0.058483448
Observations	24

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.006281025	0.006281025	1.836388596	0.189126727
Residual	22	0.075246902	0.003420314		
Total	23	0.081527927			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.018203442	0.012677335	1.435904478	0.165096959	-0.008087741	0.044494626	-0.008087741	0.044494626
X Variable 1	0.869137911	0.641366689	1.355134162	0.189126727	-0.460975187	2.199251009	-0.460975187	2.199251009



2 Year Regression 72 Months

SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.448651013
R Square	0.201287732
Adjusted R Square	0.189877557
Standard Error	0.085250338
Observations	72

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.128208615	0.128208615	17.64107275	7.73107E-05
Residual	70	0.508733407	0.00726762		
Total	71	0.636942022			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.024517784	0.010047371	2.440218851	0.017213195	0.004478935	0.044556633	0.004478935	0.044556633
X Variable 1	1.157461528	0.275577699	4.200127706	7.73107E-05	0.607839145	1.70708391	0.607839145	1.70708391

SUMMARY OUTPUT

60 Months

<i>Regression Statistics</i>	
Multiple R	0.450812936
R Square	0.203232303
Adjusted R Square	0.189494929
Standard Error	0.077870865
Observations	60

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.089709619	0.089709619	14.79411578	0.000300674
Residual	58	0.351704553	0.006063872		
Total	59	0.441414171			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.02301366	0.010098729	2.278866974	0.02637353	0.002798858	0.043228463	0.002798858	0.043228463
X Variable 1	1.125169487	0.29253204	3.846311972	0.000300674	0.539602993	1.710735981	0.539602993	1.710735981

SUMMARY OUTPUT

48 Months

<i>Regression Statistics</i>	
Multiple R	0.213172341
R Square	0.045442447
Adjusted R Square	0.024691196
Standard Error	0.066004362
Observations	48

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.009540315	0.009540315	2.189865411	0.145738076
Residual	46	0.20040249	0.004356576		
Total	47	0.209942804			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.030878751	0.01006307	3.068521928	0.003600327	0.010622842	0.051134659	0.010622842	0.051134659
X Variable 1	0.650910714	0.439858216	1.479819385	0.145738076	-0.234477939	1.536299367	-0.234477939	1.536299367

SUMMARY OUTPUT

36 Months

<i>Regression Statistics</i>	
Multiple R	0.19563028
R Square	0.038271206
Adjusted R Square	0.009985066
Standard Error	0.064018984
Observations	36

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.005545185	0.005545185	1.353002041	0.252852813
Residual	34	0.139346631	0.00409843		
Total	35	0.144891816			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.023630228	0.010986326	2.150876268	0.03868112	0.001303327	0.045957128	0.001303327	0.045957128
X Variable 1	0.615716993	0.529336588	1.163186159	0.252852813	-0.460024376	1.691458361	-0.460024376	1.691458361

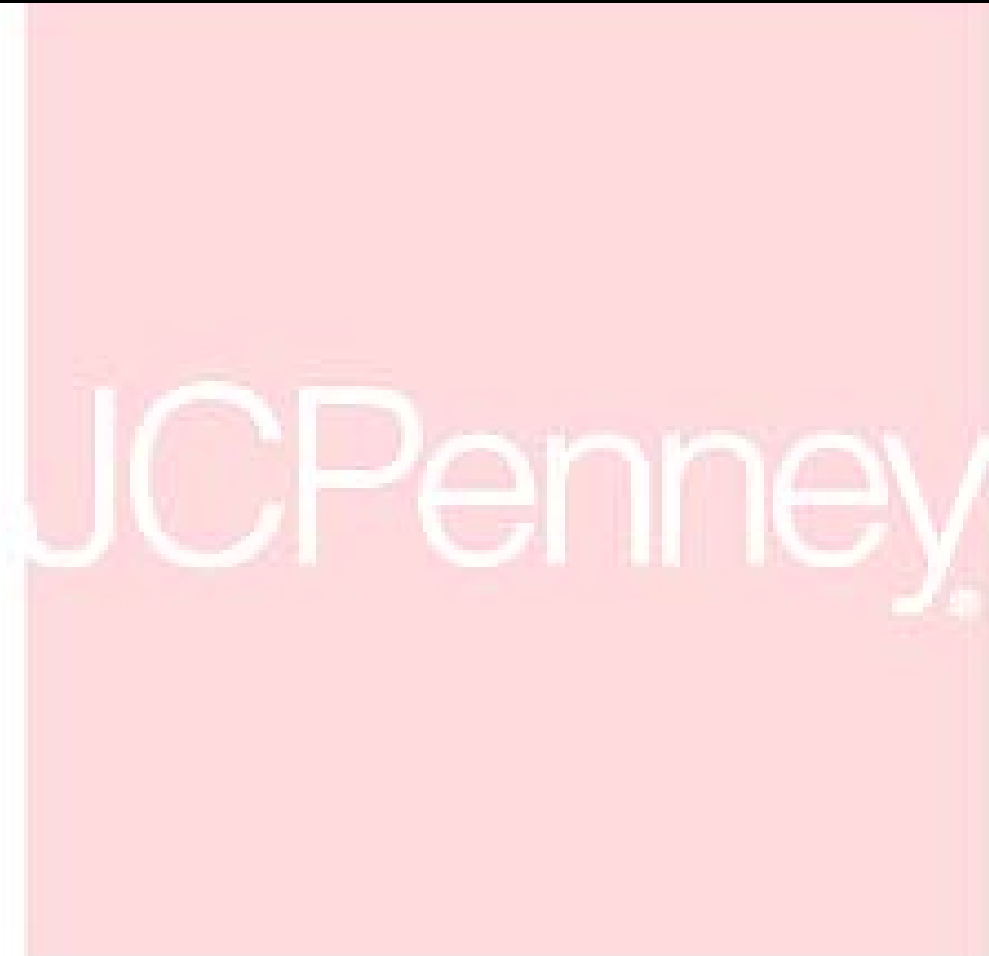
2 Year Regression
24 Months

SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.27764037
R Square	0.077084175
Adjusted R Square	0.035133456
Standard Error	0.058482093
Observations	24

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.006284513	0.006284513	1.837493524	0.188998865
Residual	22	0.075243414	0.003420155		
Total	23	0.081527927			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.018129626	0.012695068	1.428084255	0.167310758	-0.008198333	0.044457585	-0.008198333	0.044457585
X Variable 1	0.869702617	0.641590417	1.355541782	0.188998865	-0.460874463	2.200279697	-0.460874463	2.200279697



5 Year Regression 72 Months

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.448165023
R Square	0.200851888
Adjusted R Square	0.189435486
Standard Error	0.085273595
Observations	72

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.127931008	0.127931008	17.59327456	7.8877E-05
Residual	70	0.509011015	0.007271586		
Total	71	0.636942022			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.025192121	0.010049758	2.506739098	0.014510075	0.005148511	0.045235731	0.005148511	0.045235731
X Variable 1	1.154714986	0.275296989	4.19443376	7.8877E-05	0.605652461	1.703777511	0.605652461	1.703777511

SUMMARY OUTPUT

60 months

Regression Statistics	
Multiple R	0.449792209
R Square	0.202313032
Adjusted R Square	0.188559808
Standard Error	0.077915774
Observations	60

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.089303839	0.089303839	14.71022631	0.000311514
Residual	58	0.352110332	0.006070868		
Total	59	0.441414171			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.02360573	0.010091237	2.339230592	0.022789282	0.003405925	0.043805536	0.003405925	0.043805536
X Variable 1	1.121509085	0.292410605	3.835391285	0.000311514	0.53618567	1.7068325	0.53618567	1.7068325

SUMMARY OUTPUT

48 months

Regression Statistics	
Multiple R	0.208538553
R Square	0.043488328
Adjusted R Square	0.022694596
Standard Error	0.066071888
Observations	48

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.009130062	0.009130062	2.091415241	0.154908451
Residual	46	0.200812743	0.004365494		
Total	47	0.209942804			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.031228196	0.010020047	3.116571909	0.003149794	0.011058888	0.051397503	0.011058888	0.051397503
X Variable 1	0.638269622	0.441350925	1.446172618	0.154908451	-0.250123698	1.526662942	-0.250123698	1.526662942

SUMMARY OUTPUT

36 months

Regression Statistics	
Multiple R	0.194625353
R Square	0.037879028
Adjusted R Square	0.009581352
Standard Error	0.064032036
Observations	36

ANOVA					
	df	SS	MS	F	Significance F
Regression	1	0.005488361	0.005488361	1.338591493	0.255346729
Residual	34	0.139403455	0.004100102		
Total	35	0.144891816			

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	0.023748778	0.01096771	2.16533597	0.037469898	0.001459709	0.046037847	0.001459709	0.046037847
X Variable 1	0.611820612	0.528810505	1.156975148	0.255346729	-0.462851627	1.686492851	-0.462851627	1.686492851

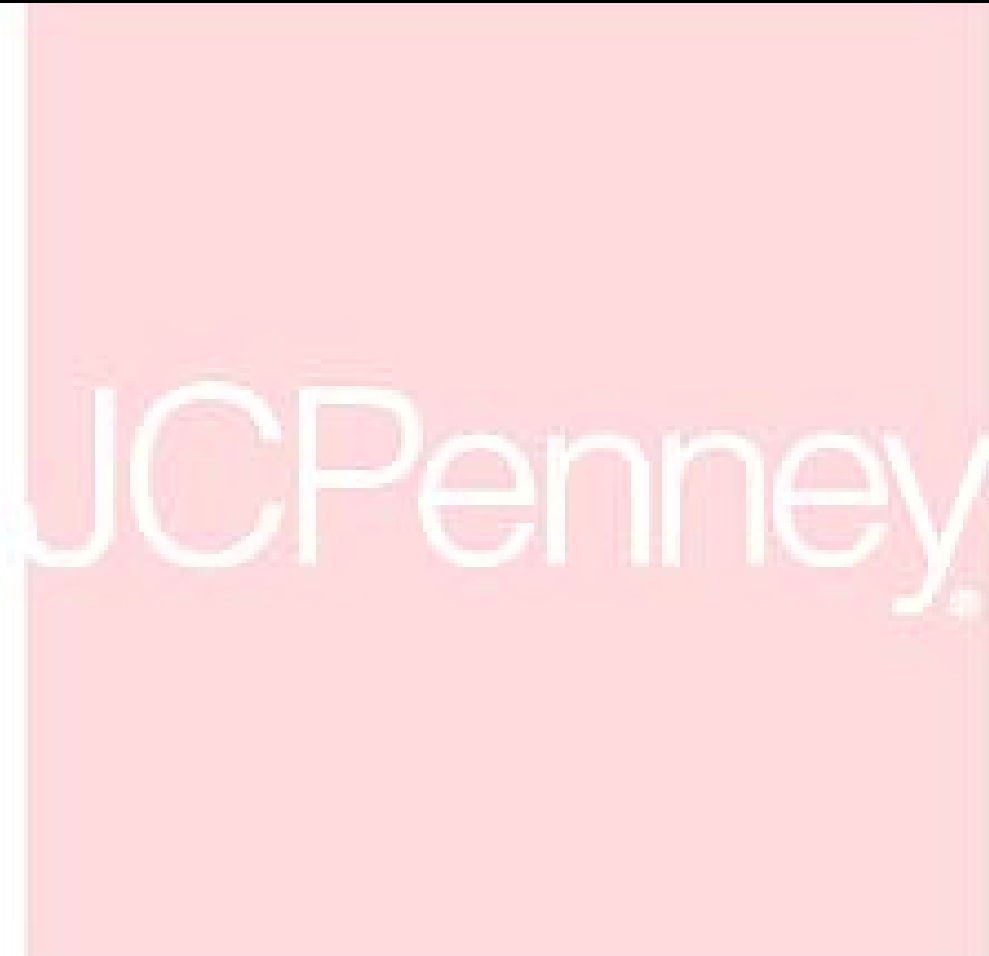
5 Year Regression
24 Months

SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.277607569
R Square	0.077065962
Adjusted R Square	0.035114415
Standard Error	0.05848267
Observations	24

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.006283028	0.006283028	1.837023129	0.189053286
Residual	22	0.075244899	0.003420223		
Total	23	0.081527927			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.018104966	0.012701569	1.425411748	0.168072753	-0.008236476	0.044446409	-0.008236476	0.044446409
X Variable 1	0.869241061	0.641332016	1.355368263	0.189053286	-0.460800129	2.199282251	-0.460800129	2.199282251



10 Year Regression 72 Months

SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.44802338
R Square	0.200724949
Adjusted R Square	0.189306734
Standard Error	0.085280367
Observations	72

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.127850155	0.127850155	17.57936319	7.9339E-05
Residual	70	0.509091867	0.007272741		
Total	71	0.636942022			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.025726439	0.010052102	2.55930935	0.012651148	0.005678154	0.045774724	0.005678154	0.045774724
X Variable 1	1.153914941	0.27521508	4.192775117	7.9339E-05	0.605015778	1.702814104	0.605015778	1.702814104

SUMMARY OUTPUT

60 months

<i>Regression Statistics</i>	
Multiple R	0.449504103
R Square	0.202053939
Adjusted R Square	0.188296248
Standard Error	0.077928426
Observations	60

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.089189472	0.089189472	14.68661734	0.000314637
Residual	58	0.352224699	0.00607284		
Total	59	0.441414171			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.024121653	0.010083032	2.392301596	0.020003754	0.003938272	0.044305033	0.003938272	0.044305033
X Variable 1	1.120279782	0.292324765	3.832312271	0.000314637	0.535128195	1.705431369	0.535128195	1.705431369

SUMMARY OUTPUT

48 months

<i>Regression Statistics</i>	
Multiple R	0.205765882
R Square	0.042339598
Adjusted R Square	0.021520894
Standard Error	0.066111551
Observations	48

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.008888894	0.008888894	2.033728779	0.160594408
Residual	46	0.20105391	0.004370737		
Total	47	0.209942804			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.031512992	0.00997864	3.158044888	0.002804139	0.011427032	0.051598951	0.011427032	0.051598951
X Variable 1	0.63097627	0.442452353	1.42608863	0.160594408	-0.25963411	1.52158665	-0.25963411	1.52158665

SUMMARY OUTPUT

36 months

<i>Regression Statistics</i>	
Multiple R	0.194433563
R Square	0.03780441
Adjusted R Square	0.00950454
Standard Error	0.064034519
Observations	36

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.00547755	0.00547755	1.335851016	0.25582454
Residual	34	0.139414266	0.00410042		
Total	35	0.144891816			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.023881239	0.010942822	2.182365759	0.036086711	0.00164275	0.046119729	0.00164275	0.046119729
X Variable 1	0.610727981	0.528407296	1.155790213	0.25582454	-0.463124839	1.684580801	-0.463124839	1.684580801

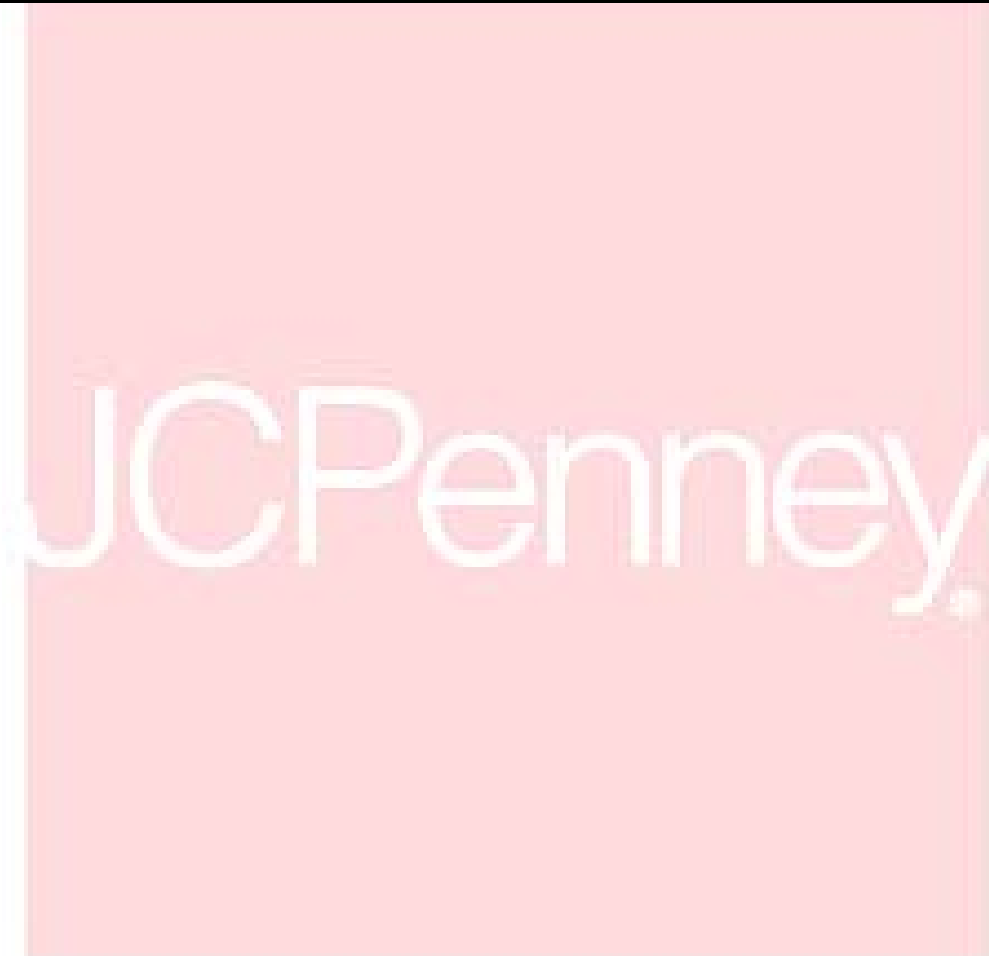
10 Year Regression
24 Months

SUMMARY OUTPUT

<i>Regression Statistics</i>	
Multiple R	0.277979006
R Square	0.077272328
Adjusted R Square	0.035330161
Standard Error	0.058476131
Observations	24

ANOVA					
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	1	0.006299853	0.006299853	1.84235421	0.188437649
Residual	22	0.075228074	0.003419458		
Total	23	0.081527927			

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>	<i>Lower 95.0%</i>	<i>Upper 95.0%</i>
Intercept	0.018154767	0.012685701	1.43112056	0.166448405	-0.008153766	0.0444633	-0.008153766	0.0444633
X Variable 1	0.87036741	0.641233282	1.357333493	0.188437649	-0.459469018	2.200203838	-0.459469018	2.200203838



Cost of Equity

0.1361

Estimated Price (Jan 2007) 3285.82
 Estimated Price per Share (Jan 2007) \$ 14.54
Implied Share Price at June 1, 2007 15.33
 Observed Share Price **\$81.99** \$94.29 \$69.69

	AT	WACC	0.0799	Kd	0.0332	Ke	0.1361					
	0	1	2	3	4	5	6	7	8	9	10	11
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Earnings		1266	1342	1422	1508	1598	1694	1796	1903	2018	2139	
Dividends		181	181	181	202	202	202	224	224	224	224	247.82
Book Value Equity	4288	5373	6534	7775	9082	10478	11970	13542	15221	17014	18928	

ROE	29.52%	24.97%	21.77%	19.39%	17.60%	16.17%	15.00%	14.06%	13.26%	12.57%
BE % G	25.30%	21.61%	19.00%	16.80%	15.38%	14.24%	13.13%	12.40%	11.78%	11.25%



	ROE					G						
	0.13	0.15	0.17	0.19	0.21	0.09	0.1	0.11	0.12	0.13		
KE	0.125	26.68	53.36	80.04	106.72	133.4	0.145	14.55	13.34	11.43	8	0
	0.13	20.01	40.02	60.03	80.04	100.05	0.14	16.01	15.01	13.34	10	0
	0.1361	15.33	30.67	46	61.33	76.66	0.1361	17.36	15.77	15.33	12.43	0
	0.14	13.34	26.68	40.02	53.36	66.7	0.13	20.01	20.01	20.01	20.01	n/a
	0.145	10.84	22.87	34.3	45.74	57.17	0.125	22.87	24.01	26.68	40.02	0
	G					ROE						
	0.09	0.1	0.11	0.12	0.13	0.21	0.19	0.17	0.15	0.13		
	0.21	52.09	60.97	76.66	111.85	262.42						
	0.19	43.4	49.89	61.33	87	196.81						
	0.17	34.72	38.8	46	62.14	131.21						
	0.15	26.04	27.71	30.67	37.28	65.6						
	0.13	17.36	16.63	15.33	12.43	0						

Weighted Average Cost of Debt and WACC

Liabilities	2006	% of TL	Interest Rate	Value Added Weight
Current liabilities				
Trade payables	1366	0.16291	5.19	0.845503
Accrued expenses and other current liabilities	1692	0.201789	5.19	1.047284
Current maturities of long-term debt	434	0.051759	7.691094	0.398084
Income taxes payable	0	0	35	0
Total current liabilities	3492	0.416458		
Long-term debt	3010	0.358974	7.691094	2.760906
Deferred taxes	1206	0.143828	4.87	0.700444
Other liabilities	677	0.080739	5.8	0.468289
Long-term liabilities	4893	0.583542		
Total Liabilities	8385	1		

Weighted Average Cost of Debt Before Taxes: 6.220509

Ke 13.61%

Weighted Average Cost of Debt After Taxes: 4.043331

$$WACC = (V_e/V_f) * k_e + (V_d/V_f) * k_d(1-t)$$

$$WACC = (4288/12673) * 13.61 + (8385/12673) * 6.22(1 - .35)$$

AT WACC 7.280

BT WACC 8.720

Tax rate used: 35% Corporate Tax Rate

** Used 17 year S&P 500 average market return

Discount Dividends Model

	0	1	2	3	4	5	6	7	8	9	10	11
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Earnings		\$ 1,266	\$ 1,342	\$ 1,422	\$ 1,508	\$ 1,598	\$ 1,694	\$ 1,796	\$ 1,903	\$ 2,018	\$ 2,139	
DPS		0.8	0.8	0.8	0.892	0.89	0.89	0.99235	0.99	0.99	0.99	0.99
Book Value of Equity	4288											
PV Factor		0.880	0.775	0.682	0.600	0.528	0.465	0.409	0.360	0.317	0.279	
PV Dividends Year by Year		\$0.70	\$0.62	\$0.55	\$0.54	\$0.47	\$0.41	\$0.41	\$0.36	\$0.31	\$0.28	
Total PV of Annual Dividends	\$4.64	30.5%										
Continuing (Terminal) Value Perpetuity												37.931
PV of Terminal Value Perpetuity	\$10.59	69.5%										
Estimated Price per Share (Jan 2007)	\$15.23	100.0%										
Implied Share Price at June 1, 2007	16.0625											
Observed Share Price	\$81.99	\$94.29	\$69.69									
Initial Cost of Equity	0.1361	over	under									
Perpetuity Growth Rate (g)	0.11											

Sensitivity Analysis

	Growth Rates				
	0.105	0.11	0.114	0.115	0.1175
0.118	25.91	41.34	77.77	102.06	587.81
0.12	23.08	34.05	50.71	63.2	121.49
0.1361	13.53	16.06	18.08	18.71	20.57
0.15	11.36	12.17	12.98	13.21	13.85
0.16	10.18	10.71	11.22	11.36	11.74

Free Cash Flow Model

WACC(AT) 0.0728 Kd 0.0551 Ke 0.1361

	0 2006	1 2007	2 2008	3 2009	4 2010	5 2011	6 2012	7 2013	8 2014	9 2015	10 2016	11 2017
Earnings		\$1,266	\$1,342	\$1,422	\$1,508	\$1,598	\$1,694	\$1,796	\$1,903	\$2,018	\$2,139	
DPS (Dividends Per Share)		0.80	0.80	0.80	0.89	0.89	0.89	0.99	0.99	0.99	0.99	0.99
Book Value Equity	\$4,288											
Cash From Operations		\$1,414	\$1,498	\$1,588	\$1,684	\$1,785	\$1,892	\$2,005	\$2,125	\$2,253	\$2,388	
Cash Investments		(\$260)	(\$272)	(\$289)	(\$307)	(\$326)	(\$346)	(\$367)	(\$390)	(\$414)	(\$439)	(\$439)
Book Value of Debt and Preferred Stock	\$8,385											
Annual Free Cash Flow		1,154	1,226	1,299	1,377	1,459	1,546	1,638	1,735	1,839	1,949	
PV Factor		0.920	0.846	0.778	0.716	0.658	0.606	0.557	0.512	0.471	0.433	
PV of Free Cash Flows		1,061	1,037	1,011	985	960	936	912	889	867	845	
Total PV of Annual Free Cash Flows	\$ 9,504											
Continuing (Terminal) Value Perpetuity												-15567
PV of Terminal Value Perpetuity	\$6,747				0.04	0.05	0.059	0.065	0.07			
Value of Firm	\$16,251			0.07	43.89	61.24	103.84	217.45	n/a			
Book Value of Liabilities	\$8,385			0.08	30.54							
Estimated Market Value of Equity	\$7,866			0.087	24.03							
Number of Shares	226			0.1	15.74							
Estimated Price per Share Jan 2007	\$34.80			0.11	10.99							
Implied Share Price at June 1, 2007	\$36.70											
Observed Share Price	\$81.99	94.29	69.69									
Initial WACC BT	0.0872	over	under									
Perpetuity Growth Rate (g)	0.059											

Sensitivity Analysis

	38.44	52	70.07	101.7	
	29.09	36.7	45.21	56.84	
	18.38	21.84	25.15	28.91	
	12.7	14.83	16.71	18.72	

Residual Income Model

WACC(AT) 0.0728 Kd 0.0332 Ke 0.1361

	0	1	2	3	4	5	6	7	8	9	10	11
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Earnings		1266	1342	1422	1508	1598	1694	1796	1903	2018	2139	
Dividends		181	181	181	202	202	202	224	224	224	224	247.82
Book Value Equity	4288	5373	6534	7775	9082	10478	11970	13542	15221	17014	18928	
Cash From Operations		\$1,414	\$1,498	\$1,588	\$1,684	\$1,785	\$1,892	\$2,005	\$2,125	\$2,253	\$2,388	
Cash Investments		-260	-272	-289	-307	-326	-346	-367	-390	-414	-439	-439
Actual Earnings		1266	1342	1422	1508	1598	1694	1796	1903	2018	2139	
"Normal" (Benchmark) Earnings		584	731	889	1058	1236	1426	1629	1843	2072	2316	
Residual Income (Annual)		682	611	533	449	362	268	166	60	-54	-177	-308
PV Factor		0.8802	0.7748	0.6819	0.6003	0.5283	0.4651	0.4093	0.3603	0.3171	0.2791	
PV of Annual Residual Income		601	473	363	270	191	125	68	22	-17	-49	
Total PV of Annual Residual Income	2046	81%										
Continuing (Terminal) Value												-
Perpetuity		0%										2263.04
PV of Terminal Value Perpetuity	-632	-25%										
Initial Book Value of Equity	4288	170%										
Estimated Price per Share (Jan 2007)	\$ 25.23	100%										
Implied Share Price at June 1, 2007	\$ 26.61											
Observed Share Price (June 1, 2007)	\$81.99	\$94.29	\$69.69									
Initial Cost of Equity	0.1361	over	under									
Perpetuity Growth Rate (g)	0											

Sensitivity Analysis

Growth Rate

	0	-0.15	-0.25	-0.4	-0.5
0.05	127.8	78.08	72.55	68.87	67.53
0.07	79.18	60.3	57.55	55.62	54.98
0.09	53.73	47.22	46.07	45.22	44.9
0.11	38.62	37.45	37.21	37.02	36.95
0.1361	26.61	28.15	28.52	28.81	28.93

AEG Model

	WACC(AT)	0.0728	Kd	0.0332	Ke	0.1361						
	0	1	2	3	4	5	6	7	8	9	10	11
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Earnings		1266	1342	1422	1508	1598	1694	1796	1903	2018	2139	
Dividends		181	181	181	202	202	202	224	224	224	224	247.82
Book Value of Equity	4288											
Core Perpetuity Component		1266										
Forecast Earnings			1342	1422	1508	1598	1694	1796	1903	2018	2139	
Drip Income			24.61	24.61	24.61	27.44	27.44	27.44	30.52	30.52	30.52	
Cumulative Dividend Income			1366.39	1446.89	1532.23	1625.52	1721.40	1823.04	1933.86	2048.07	2169.12	
"Normal" Annual Income (Benchmark)			1438.11	1524.40	1615.86	1712.81	1815.58	1924.52	2039.99	2162.39	2292.13	
Annual AEG			-71.72	-77.50	-83.63	-87.29	-94.18	-101.47	-106.12	-114.32	-123.01	-131
PV Factor			0.880	0.775	0.682	0.600	0.528	0.465	0.409	0.360	0.317	
PV AEG (Annual)			-63.13	-60.05	-57.03	-52.40	-49.76	-47.19	-43.44	-41.19	-39.01	
Total PV of AEG		-453.20										
Value of AEG Perpetuity												
Present Value of AEG Perp + to Core		-145.21										
Total Adjusted T+1 Perpetuity		667										
Capitalization Rate (Ke)		0.1361										
Value of Equity		4903.91										
Estimated Price per Share (Jan 2007)	21.70											
Implied Share Price June 1 ,2007	22.88											
Observed Share Price	\$81.99											
Perpetuity Growth Rate (g)	-0.15											

Sensitivity Analysis

	0	-0.15	-0.25	-0.4	-0.5
0.05	47.35	62.29	65.8	68.61	69.75
0.07	33.82	44.49	47	49.01	49.82
0.09	26.31	34.61	36.56	38.12	38.75
0.11	21.52	28.31	29.91	31.19	31.7
0.1361	17.4	22.88	24.17	25.21	25.62

94.2885 69.6915
over under

AEG=RI Proof

	WACC(AT)	0.0728	Kd	0.0332	Ke	0.1361					
	2008	2009	2010	2011	2012	2013	2014	2015	2016		
Annual AEG	71.72	-77.50	-83.63	87.29	94.18	101.47	106.12	114.32	123.01		
Change in RI	71.72	-77.50	-83.63	87.29	94.18	101.47	106.12	114.32	123.01		

Z-Score Analysis

		2002	2003	2004	2005	2006
Z-Score	1.2	4,194	2,759	4,980	3,940	3,156
=	$\frac{\text{Working Capital}}{\text{Total Assets}}$	17,867	18,300	14,127	12,461	12,673
	1.4	2,817	1,728	812	512	922
	$\frac{\text{Retained Earnings}}{\text{Total Assets}}$	17,867	18,300	14,127	12,461	12,673
	3.3	1,107	790	1,312	1,577	1,922
	$\frac{\text{EBIT}}{\text{Total Assets}}$	17,867	18,300	14,127	12,461	12,673
	0.6	4,533	10,346	14,249	15,096	18,530
	$\frac{\text{Market Value of Equity}}{\text{Book Value of Liabilities}}$	11,497	12,875	9,271	8,454	8,385
	1	32,347	17,786	18,424	18,781	19,903
	$\frac{\text{Sales}}{\text{Total Assets}}$	17,867	18,300	14,127	12,461	12,673
Raw		2002	2003	2004	2005	2006
		0.2347	0.1508	0.3525	0.3162	0.2490
		0.1577	0.0944	0.0575	0.0411	0.0728
		0.0620	0.0432	0.0929	0.1266	0.1517
		0.3942	0.8036	1.5370	1.7857	2.2099
		1.8104	0.9719	1.3042	1.5072	1.5705
Weighted		2002	2003	2004	2005	2006
		0.2817	0.1809	0.4230	0.3794	0.2988
		0.2207	0.1322	0.0805	0.0575	0.1019
		0.2045	0.1425	0.3065	0.4176	0.5005
		0.2365	0.4822	0.9222	1.0714	1.3259
		1.8104	0.9719	1.3042	1.5072	1.5705
Z-score		2.7539	1.9096	3.0363	3.4332	3.7976

References

1. Dillard's Website: www.dillards.com
2006 Annual Report
2002 10K -2007 10K
2. JC Penney Website: www.jcpenney.com
2006 Annual Report
2002 10K -2007 10K
3. Kohl's Website: www.kohls.com
2006 Annual Report
2002 10K -2007 10K
4. Stage Stores Website: www.stagestores.com
2006 Annual Report
2002 10K -2007 10K
5. Stein Mart Website: www.steinmart.com
2006 Annual Report
2002 10K -2007 10K
6. Capital Resources: www.cr-ny.com
7. First Research: www.firstresearch.com
8. Google Finance: www.finance.google.com
9. Investopedia: www.investopedia.com
10. Market Watch: www.marketwatch.com
11. MSN Money: <http://moneycentral.msn.com>
12. NetMBA: www.netmba.com
13. Reuters: www.reuters.com
14. St. Louis Federal Reserve Bank: www.stlouisfed.org/fred02
15. Wall Street Journal: <http://online.wsj.com>
16. Yahoo Finance: www.finance.yahoo.com