

Kohls Corp. (KSS)

July 2, 2012

Price: \$45.4

Diluted Shares Out: 240 million

Market Cap: \$10,900 million

Net Cash: -\$1,100 million (April 2012)

EV: \$12,000 million (estimated)

KSS SELECTED FINANCIALS 2002 – 2012

Fiscal Year	Sales	Op Income	Net Income	EPS	OCF	Capex	FCF	DPS	Shares
2002	9,120.3	1,077.7	635.5	1.85	670	(748)	(79)	0.00	346.7
2003	10,282.1	951.4	546.5	1.59	740	(857)	(118)	0.00	344.9
2004	11,700.6	1,193.3	703.4	2.04	937	(919)	18	0.00	344.8
2005	13,444.4	1,416.2	842.0	2.43	908	(855)	54	0.00	346.8
2006	15,597.0	1,815.0	1,109.0	3.31	3,120	(1,163)	1,957	0.00	335.0
2007	16,474.0	1,804.0	1,084.0	3.39	1,205	(1,542)	(337)	0.00	320.0
2008	16,389.0	1,654.0	857.0	2.80	1,752	(1,066)	686.0	0.00	307.0
2009	17,178.0	1,859.0	973.0	3.17	2,286	(675)	1,611	0.00	306.0
2010	18,391.0	2,092.0	1,120.0	3.66	1,756	(801)	955.0	0.00	306.0
2011	18,804.0	2,158.0	1,167.0	4.30	2,143	(927)	1,216.0	1.00	271.0
4/28/2012	18,885.0	2,088.0	1,120.0	4.31	2,193	(883)	1,310.0	0.75	245.0

Note: All figures in \$millions except for EPS, DPS

Fiscal Year end: Saturday closest to January 31st.

Company Description:

Kohl's Corporation (the "Company" or "Kohl's" or "KSS") was organized in 1988 and is a Wisconsin corporation. Kohl's operates family-oriented department stores that sell moderately priced apparel, footwear and accessories for women, men and children; soft home products such as sheets and pillows; and housewares. Their stores generally carry a consistent merchandise assortment with some differences attributable to regional preferences. KSS stores feature quality private and exclusive brands which are found "Only at Kohl's" as well as national brands. As of May 10, 2012, Kohl's operated 1,134 stores in 49 states. At the time of their initial public offering in 1992, Kohl's had 79 stores in the Midwest.

KSS mission statement reads "To be the leading family-focused, value-oriented, specialty department store offering quality exclusive and national brand merchandise to the customer in an environment that is convenient, friendly and exciting."

Business:

The merchandise mix is shown below

	<u>2011</u>	<u>2010</u>	<u>2009</u>
Women's	31%	31%	31%
Men's	19%	19%	19%
Home	19%	19%	19%
Children's	13%	12%	13%
Accessories	10%	10%	10%
Footwear	8%	9%	8%
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>

In addition, Kohl's offers on-line shopping on its website at www.Kohls.com. Launched in 2001 as an added service for customers who prefer to shop using the internet, the website has grown to include a selection of items and categories beyond what is available in stores, with a primary focus on extended sizes, product line extensions, and web-exclusive product lines. The website is designed to provide a convenient, easy-to-navigate, on-line shopping environment that complements the in-store focus. E-commerce sales hit \$1 billion in 2011.

The success of their recently-launched brands, as well as the growth of their other exclusive and private brands, continue to drive increased penetration of exclusive and private brand sales as a percentage of total sales. This penetration increased approximately 240 basis points to 50.3% for 2011. Sales of private brands were 25% in 2004.

Store Growth

Kohl's has grown store base tremendously over the last decade with store count increasing from 457 in 2002 to 1,127 at the end of 2011. As Kohl's store base has matured, it is slowing down the rate of opening new stores. KSS will open 20 stores in 2012 (down from 40 in 2011). Most of the stores will be smaller stores ranging from 55k to 68k square feet.

Remodels

Remodels are also an important part of their in-store shopping experience initiatives as KSS believes it is extremely important to maintain their existing store base. Kohl's completed 100 store remodels in 2011, 85 in 2010 and 51 in 2009. KSS currently plans to remodel approximately 50 stores in 2012. As of year-end, approximately one-half of their stores were either new or remodeled in the last five years. *We have effectively compressed the remodel duration period which minimizes costs and disruption to our stores and benefits our sales and customer experience. We expect a typical remodel in 2012 will take seven weeks; a reduction of approximately 50 percent since 2007.*

Competition

KSS operates in a highly competitive retail industry and faces strong competition from other department stores such as Macy's (M), JC Penney (JCP), Dillards (DDS) as well as general retailers like Walmart (WMT), Target (TGT) and specialty retailers in its various categories.

Purchasing

KSS purchases merchandise from numerous domestic and foreign suppliers. Approximately 25% of the merchandise is sourced through a third party purchasing agent. None of their vendors individually accounted for more than 5% of net purchases during 2011.

Distribution

We receive substantially all of our merchandise at our nine retail distribution centers. A small amount of our merchandise is delivered directly to the stores by vendors or their distributors. The retail distribution centers, which are strategically located through the United States, ship merchandise to each store by contract carrier several times a week. We also operate fulfillment centers in Monroe, Ohio; San Bernardino, California; and Edgewood, Maryland that service our E-Commerce business. We expect to open a fourth E-Commerce fulfillment center in Texas in the summer of 2012.

Stores

Their typical, or “prototype,” store has approximately 88,000 gross square feet of retail space and serves trade areas of 150,000 to 200,000 people. Most “small” stores are 55,000 to 68,000 square feet and serve trade areas of 100,000 to 150,000 people. The “urban” stores, currently located in the New York and Chicago markets, serve very densely populated areas of up to 500,000 people and average approximately 125,000 gross square feet of retail space.

Their typical lease has an initial term of 20-25 years and four to eight renewal options for consecutive five-year extension terms. Substantially all of the leases provide for a minimum annual rent that is fixed or adjusts to set levels during the lease term, including renewals. Approximately one-fourth of the leases provide for additional rent based on a percentage of sales over designated levels.

	Number of Stores by Store Type		
	2010	Net Additions	2011
Prototype	978	9	987
Small	106	29	135
Urban	5	—	5
	<u>1,089</u>	<u>38</u>	<u>1,127</u>

	Number of Stores by Ownership		
	2010	Net Additions	2011
Owned	382	21	403
Leased*	707	17	724
	<u>1,089</u>	<u>38</u>	<u>1,127</u>

Advertising

Advertising costs, which include primarily television and radio broadcast, direct mail, and newspaper circulars were 5.1% of Sales in 2011.

Seasonality

Their business, like that of most retailers, is subject to seasonal influences. The majority of sales and income is typically realized during the second half of each fiscal year. The back-to-school season extends from August through September and represents approximately 15% of their annual sales. Approximately 30% of the sales occur during the holiday season in the months of November and December.

Profitability of the business SGA includes store payroll, rent, warehousing, distribution, transportation, advertising, purchasing, insurance and overhead.

	FY 2011	FY 2010	FY 2009	FY 2008	FY 2007
Revenue	100%	100%	100%	100%	100%
Gross Margin	38.2%	38.2%	37.8%	36.9%	36.5%
Op Margin	11.5%	11.4%	10.8%	10.1%	11.7%
Net Margin	6.2%	6.1%	5.7%	5.2%	6.4%
ROE	16.4%	14.1%	13.8%	13.8%	18.8%

An important aspect of our pricing strategy and overall profitability is a culture focused on maintaining a low-cost structure. Critical elements of this low-cost structure are our unique store format, lean staffing levels, sophisticated management information systems and operating efficiencies which are the result of centralized buying, advertising and distribution.

As can be seen in the table above, gross margins have been more or less stable around the 38% mark in the last three years. The Operating margin has held steady in the 11% range and has improved from 10.1% in 2008 to 11.5% in 2011.

Balance Sheet (as of April 30, 2011)

- KSS has a healthy balance sheet with \$1029 million in cash.
- LT Debt is \$2141million at an effective interest rate of 6%.
- Net debt of \$1.1 billion. (I have ignored the capital lease obligation of \$2billion from the balance sheet)
- Merchandise Inventories worth \$3400 million
- LT Investments consist of auction rate securities whose fair value was \$156 million (par value \$192 million)
- Working capital \$2billion (Total Current assets: \$4850 million, Total Current liabilities: \$2900 million)
- Interest payment of \$300 million is well covered with operating income. Actually interest payment is \$120 million and the rest is rent expense that is classified as interest due to the accounting of the capital leases.

Retail Specific Data

Year	Sales \$mm	Gross Margin %	Op Margin %	Sales per Selling Sq Feet	No. Stores	SSS %
2002	9120	34.4	11.8	\$284	457	5.3
2003	10282	33	9.3	\$268	542	-1.6
2004	11701	35.2	10.2	\$255	637	0.3
2005	13444	35.6	10.5	\$252	732	3.4
2006	15597	36.4	11.6	\$256	817	5.9
2007	16474	36.5	11	\$249	929	-0.8
2008	16389	36.9	10.1	\$222	1004	-6.9
2009	17178	37.8	10.8	\$217	1058	0.4
2010	18391	38.2	11.4	\$222	1089	4.4
2011	18804	38.2	11.5	\$220	1127	0.5

Advantages over competition

Kohls had 1,127 stores at the end of FY 2011 with gross square footage of 98 million (82 million retail selling square footage) for an average 87,000 square feet per store. This is much smaller in comparison to comps Macy's (M) – 180k, JC Penney (JCP) – 101k and Dillards (DDS) – 173k. Hence, Kohl's SGA costs are the lowest in the industry at the per store level. This is a clear advantage.

Another advantage from smaller stores is high sales per square feet (both gross and selling). KSS with \$196 per square feet is much higher than the comps (excluding Nordstrom).

	Sales / Gross Sq Feet	SGA/Sq Feet	Sales/Store	SGA/Store	Gross Sq Ft/Store
JWN	\$429	\$115	\$46.7 m	\$12.5m	109k
M	\$174	\$55	\$31.4m	\$9.8m	180k
DDS	\$119	\$31	\$20.6m	\$5.4m	173k
JCP	\$155	\$46	\$15.7m	\$4.6m	101k
KSS	\$196	\$44	\$16.7m	\$3.8m	87k

KSS also has continued to expand by adding 198 stores (from 929 at the end of 2007 to 1127 stores at the end of 2011) and 12 million of selling square feet (from 70m to 82m square feet) in the last four years.

Management:

Mr. Mansell is responsible for Kohl's strategic direction, long-term growth and profitability. He has served as Chairman since September 2009, Chief Executive Officer since August 2008 and President and Director since February 1999. He served as Executive Vice President—General Merchandise Manager from 1987 to 1998. Mr. Mansell joined Kohl's as a Divisional Merchandise Manager in 1982. Mr. Mansell has 36 years of experience in the retail industry.

The other members of the management team such as Mr. Brennan (Chief Merchandising Officer), Mr. Worthington (Chief Administrative Officer), Mr. Bonning (Sr. VP) have an average 26 years of experience in the retail industry.

Why is the price cheap?

Weak Q4 and lower GM in Q1, weak guidance for Q2. Street possibly expecting downward revision of EPS guidance.

Slow growth: KSS plans to open 20 new stores annually going forward v/s 40 new stores in 2011. 2-3% top line growth.

Weak SSS in recent months: SSS decreased 4.2% for May and total sales decreased 2.6%. Kevin Mansell, Kohl's chairman, president and chief executive officer, commented, "*May sales were lower than our expectations and, as a result, we now expect second quarter comparable store sales to be modestly negative.*"

11/29/2012: Stock down 10% on 5% drop in sales in Nov and 5.6% drop in SSS.

Valuation

At the current price of \$45.4 and with 240m shares outstanding (Q1 10Q), KSS is valued at a market cap of \$10.9 billion and trades at a P/E of 10. KSS has about \$1100 million in net debt (ignoring leases) on its balance giving an Enterprise Value of \$12 billion. Using FY 2011 Operating Income of \$2158 million, I get a multiple of 5.5x EV to Op Income.

Average FCF in 2010 and 2011 was \$1085 million and management has guided to FY 2012 of \$1 billion (close to the average). On a P to FCF basis, KSS is trading at about 10.9x the FY 2012 expected FCF. On an EV to FCF (excluding interest), we find the multiple is 11.2x. Management has provided the breakup of the FY 2012 capital expenditure between spending on growth initiatives such as the twenty new stores and the additional data center in Texas and remodeling and IT upgrades. The maintenance capex comes to about \$520 million and about \$300m of growth capex. If we use this mcapex, then EV to MFCF (ex int) is 8.7x

Cash from operations has averaged \$2100 million over the last two years. KSS is trading at only 5.7x this average OCF.

FCF multiple	12x	13x	14x
Market Cap	\$12,200m	\$13,300m	\$14,400m
Expected share price	\$55	\$60	\$65

Assumptions: 220 million diluted shares, \$1000 million net debt and \$1100 million FCF.

Assumptions: With 240 million outstanding at the end of Q2 and \$900m left in the share repurchase program, I assume KSS can buy back about 20 million shares in the next 12 months. I assume FCF increases by 10% as the spending for the distribution center ends and the smaller stores are cheaper to open.

The estimated valuation range is \$55-\$65. If we take the mid-point \$60 as the target price, we would need to buy shares at 30% discount to have a decent margin of safety. That means a \$42 price as the target purchase price.

Historical: Taken from Capital IQ, we can see KSS is trading below average valuation on all metrics.

Historical Valuation	2/3/2007	2/2/2008	1/31/2009	1/30/2010	1/29/2011	1/28/2012	Average	Today
EV/Sales	1.48	1.32	0.88	0.96	0.89	0.83	1.06	0.6
EV/EBITDA	11.0	9.2	6.6	7.6	6.5	5.7	7.8	4.0
EV/EBIT	13.6	11.2	8.4	10.3	8.8	7.7	10.0	5.4
P/E	22.9	18.1	12.8	16.8	15.5	13.3	16.6	10.1

DCF: To see what is implied by current stock price, I used a DCF with 1% FCF growth rate, no share buyback/dilution, discount rate of 11% and starting FCF as \$1000 million and share count as 220 million to arrive at an intrinsic value of \$44.

Comps

Name	Kohl's Corp.	Macy's, Inc.	J. C. Penney	Dillards
Share Price	\$45.4	\$34	\$22.7	\$63.6
Mcap	10,900	14,000	5,000	\$3100
EV	12,000	19,000	7,263	\$3500
P/E	10x	11x	NM	7x
EV/EBIT	5.5x	7.8x		8.8x
EV/SALES	0.6x	0.7x	0.44x	0.55x
Dividend Yield	2.8%	2.3%	-	0.3%
EV/OCF	5.7x	8.3x		7x

As can be seen from the first table above, KSS is valued the cheapest compared to the comps when using EV to OCF or EV to EBIT. It has the best dividend yield. If you consider the operating performance, KSS has the most stable and predictable performance with one of the best operating margins.

Other assets

KSS owns 403 stores. KSS owns all of the distribution centers except Corsicana, Texas, which is leased. KSS owns the corporate headquarters in Menomonee Falls, Wisconsin.

Risks

- *Growth in our E-Commerce business could adversely affect some of our operating metrics.*

In recent years, we have experienced significant growth in our E-Commerce business. Some of this growth has resulted in lower sales in our stores. Though this has no impact on our consolidated sales, it has had a negative affect on our net income as a percentage of sales as our stores are currently more profitable than our E-Commerce business. This profitability variance is due to a variety of factors

including, but not limited to, a higher mix of lower margin merchandise in our E-Commerce business, shipping costs, and investments to provide the infrastructure necessary to grow the E-Commerce business. Though we are aggressively working to improve the profitability of our E-Commerce business, there can be no assurances that our E-Commerce business will become as profitable as our stores.

- Credit card operations

Our credit card operations facilitate sales in our stores and generate additional revenue from fees related to extending credit. The proprietary Kohl's credit card accounts have been sold to an unrelated third-party, but we share in the net risk-adjusted revenue of the portfolio, which is defined as the sum of finance charges, late fees and other revenue less write-offs of uncollectible accounts. Changes in funding costs related to interest rate fluctuations will be shared similar to the revenue if interest rates exceed defined amounts. Though management currently believes that increases in funding costs will be largely offset by increases in finance charge revenue, increases in funding costs could adversely impact the profitability of this program.

2011 Results

Total net sales for 2011 were \$18.8 billion, a 2.2% increase over 2010. Comparable store sales increased 0.5% over 2010. Comparable sales were driven by a 6.6% increase in average unit retail price, which was largely offset by decreases in units per transaction and number of transactions. The E-Commerce business met the \$1 billion revenue goal for the year and contributed 150 basis points to the comparable store sales increase. The Northeast region and the Accessories and Home businesses reported the strongest comparable store sales growth.

Gross margin was essentially flat to 2010 at 38.2% of sales for 2011. KSS successfully managed apparel cost inflation throughout the year, but saw lower margins during the fourth quarter holiday season due to the extremely competitive landscape and sales were below management expectations.

Expense management contributed to a 4% increase in net income and a 17% increase in diluted earnings per share. For 2011, net income was \$1.2 billion, or \$4.30 per diluted share, compared to \$1.1 billion, or \$3.66 per diluted share for 2010.

2012 Outlook (from 10-K)

During 2011, KSS experienced 10 – 15% increases in apparel costs and was aggressive in passing these higher costs to customers. In 2012, KSS expects to see modest cost increases in the first six months of the year, but to see decreases in the last six months of the year. KSS plans to be less aggressive about passing higher costs on to their customer in 2012. Management expects this change to have a positive impact on sales, but a negative impact on gross margin rate.

Management current expectations for fiscal 2012 compared to 2011 are as follows:

Total sales	Increase	4.5%
Comparable store sales	Increase	2%
Gross margin as a percent of sales	Decrease	70 bp
SG&A	Increase	3%
Earnings per diluted share		\$4.75

Fiscal 2012 is a 53-week year. Excluding the impact of the 53rd week, KSS expects total sales to increase 3.5%, SG&A to increase 2% and earnings per diluted share to be \$4.65. The guidance assumes share repurchases of \$1 billion at an average price of \$55 per share.

KSS expects to open approximately 20 new stores in 2012. Substantially all of the stores will be “small” stores with less than 64,000 square feet of retail space.

FY 2012 Q1 results

- Net Sales were \$4.2b an increase of 1.9%
- SSS increased only 0.2%
- Net Income of \$154m (\$0.63 per diluted share) compared to \$201m (\$0.69 per diluted share)
- Declared quarterly dividend of \$0.32 per share
- Opened 9 stores and closed one store.
- Plans to open 10 more stores in fall.
- \$1b in cash and \$2.1b in LT debt.

Guidance for Q2:

- \$0.96 to \$1.02 per diluted share on total sales growth of 2-3% and SSS of flat to 1%.
- Expected share repurchase of \$250m
- Maintains 2012 guidance of \$4.75 per diluted share

Summary:

Kohl's is an extremely well managed department store retailer. KSS has competitive advantage over their competition as their stores are smaller in size, off mall, have lower rents and lower SGA per store. Sale per square feet is also higher as a result of more efficiently run stores. KSS produces consistent free cash flows and has been aggressively buying back shares. Share count is down from 300m to 240m and is expected to be 220-225m by end of FY 2012. KSS started paying a dividend in 2011 and increased it by 28% to yield close to 3% with a 28% payout. KSS valuation @11x expected FCF is quite compelling.

Management is focused on growing store base by 2% via opening 20 new stores. I would recommend a XX% position in KSS at prices around \$40-\$44.