



KSS BEST IDEA SHORT

PUTTING CREDIT TO THE TEST

MAY 12, 2015

DISCLAIMER

DISCLAIMER

Hedgeye Risk Management is a registered investment advisor, registered with the State of Connecticut. Hedgeye Risk Management is not a broker dealer and does not provide investment advice for individuals. This research does not constitute an offer to sell, or a solicitation of an offer to buy any security. This research is presented without regard to individual investment preferences or risk parameters; it is general information and does not constitute specific investment advice. This presentation is based on information from sources believed to be reliable. Hedgeye Risk Management is not responsible for errors, inaccuracies or omissions of information. The opinions and conclusions contained in this report are those of Hedgeye Risk Management, and are intended solely for the use of Hedgeye Risk Management's clients and subscribers. In reaching these opinions and conclusions, Hedgeye Risk Management and its employees have relied upon research conducted by Hedgeye Risk Management's employees, which is based upon sources considered credible and reliable within the industry. Hedgeye Risk Management is not responsible for the validity or authenticity of the information upon which it has relied.

TERMS OF USE

This report is intended solely for the use of its recipient. Re-distribution or republication of this report and its contents are prohibited. For more details please refer to the appropriate sections of the Hedgeye Services Agreement and the Terms of Use at www.hedgeye.com

PLEASE SUBMIT QUESTIONS* TO

QA@HEDGEYE.COM

**ANSWERED AT THE END OF THE CALL*

KEY CONCLUSIONS

1

AFTER 1H, THE FINANCIAL MODEL DOES NOT WORK

Somehow KSS managed to get 1Q consensus numbers below last year despite a -9% EPS growth comp. At the same time, all indications are that 1Q comps are trending up 4% with controlled levels of working capital industry-wide. This will be a good quarter for KSS, and the market knows it.

2

CREDIT IS A SIGNIFICANT UNDERAPPRECIATED RISK

There are several issues here. 1) How much credit has been driving the bottom line, 2) why KSS has had so many changes in who underwrites its program, and 3) how well this illustrates the challenges KSS faces in its core.

3

WE SURVEYED 1,000 CONSUMERS IN DETAIL

It confirmed our suspicion that not only is credit critical for KSS, but it is equally as critical for its customers. Importantly, incremental customers with KSS' Y2Y program are lower on the credit curve. All in, we're taking up our long-term SG&A estimate due to lower credit income. Ultimately, our numbers trend to \$2.50 a share vs the Street near \$6.00.

EARNINGS SUMMARY

Kohl's

\$74.30

Financial and Valuation Summary

FY14 ends Jan 2015

	1QE	2015E	2016E	2017E	2018E	2019E
Hedgeye EPS (\$)	0.61	3.90	3.74	3.47	2.98	2.53
Consensus (\$)	0.55	4.56	5.05	5.58	6.22	6.22
Variance %	11.8%	-14.3%	-25.9%	-37.8%	-52.0%	-59.2%
Sales (\$MM)		19,403	19,748	20,015	20,140	20,340
EBIT Margin		7.9%	7.3%	6.7%	5.8%	5.0%
EBITDA (\$MM)		2,465	2,404	2,310	2,160	2,032
FCF Per Share (\$)		4.67	4.92	5.04	5.24	5.01
Book Value Per Share (\$)		29.37	29.19	28.54	26.99	24.50
Net Debt to Total Capital		22.0%	22.1%	23.2%	25.4%	30.0%
P/E		19.0 x	19.9 x	21.4 x	24.9 x	29.3 x
EV/EBITDA		6.7 x	6.6 x	6.7 x	6.9 x	7.2 x
Price/Book		2.5 x	2.5 x	2.6 x	2.8 x	3.0 x
Cash Yield		6.3%	6.6%	6.8%	7.1%	6.7%

Targeted Valuation Range

	EPS %	P/E	Price	EV/EBITDA
2015E	-8.5%	11.0 x	43	4.1 x
2016E	-4.1%	12.0 x	45	4.2 x
2017E	-7.2%	12.0 x	42	4.0 x
2018E	-14.1%	12.0 x	36	3.7 x
2019E	-15.0%	12.0 x	30	3.4 x

Investment Thesis Snapshot

1. We don't buy the premise that the business structurally improved. After easy 1Q, the P&L gets UGLY.
2. KSS arguably might not grow EPS again for 5-years, including financial engineering. Credit is a big risk here -- for reasons that most people don't see or care about.
3. If our numbers are right, we're looking at 50% downside in the stock.

A photograph of a Kohl's retail store at dusk. The building is a large, modern structure with a mix of grey and tan panels. The 'KOHLS' logo is prominently displayed in large, white, three-dimensional letters on the left side of the facade. To the right, there is a glass-enclosed entrance area with a small overhang. Several palm trees and other plants are planted along the base of the building. The sky is a deep blue with some light clouds. The foreground shows a wet, reflective surface, likely a parking lot, with white painted lines.

KOHLS

LET'S GET 1Q OUT OF THE WAY

1Q15 PUTS & TAKES

4-5%

Comp Store Sales	Hedgeye	Consensus
	4.0%	2.5%
Revenue	4,240	4,187
Revenue Growth	4.2%	2.9%
Gross Margin	36.5%	36.6%
Gross Profit Growth	3.3%	2.3%
SG&A Growth	3.5%	4.4%
D&A Growth	8.8%	6.9%
EBIT Margin	6.5%	6.1%
EBIT Growth	-1.5%	-8.9%
Interest	(84)	(85)
Shares Outstanding	197	196
EPS	\$0.61	\$0.55
EPS Growth	1.9%	-8.5%

Positive store comps coupled with 30% DTC comps, as industry laps 2nd easiest comp in past 20 quarters

Gross margin - headwind from beauty liquidation and higher e-comm mix

SG&A - deleverages by 20bps from beauty & BOPIS rollout

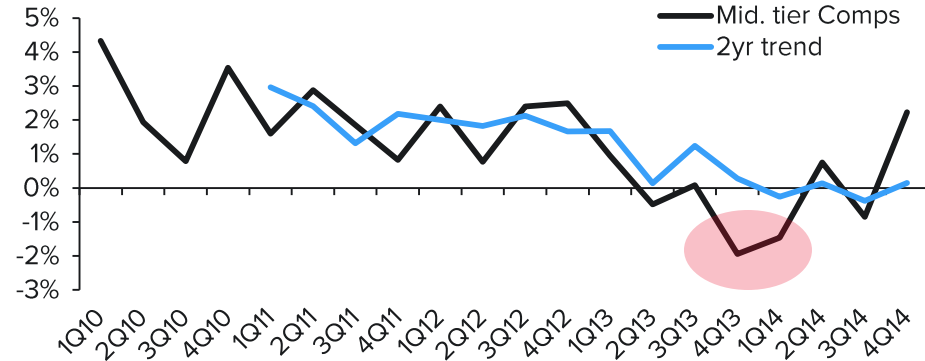
D&A - picks up as company laps \$64mm miss LY from initial guide

Interest expense flat - \$335mm for full year

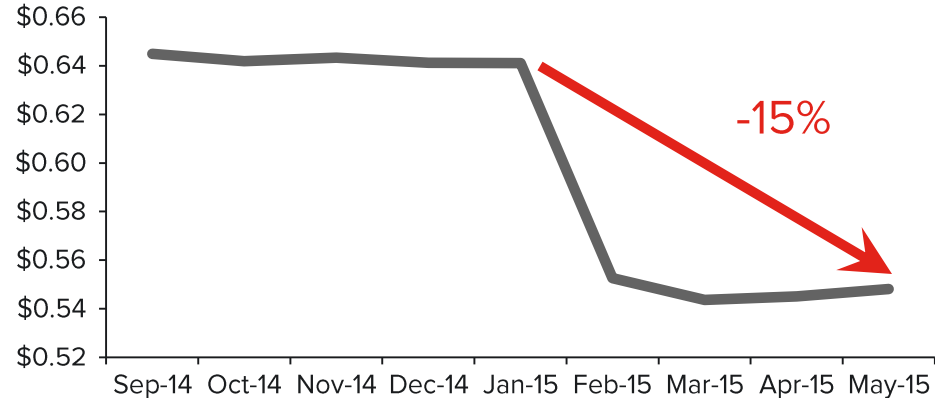
Share count comes down by 4mm sequentially, leverages down EBIT into 2% earnings growth

MID-TIER DEPT STORE COMP TREND

***Tickers: KSS, M, DDS, BONT, Belk, SHLD



KSS - 1Q15 CONSENSUS ESTIMATES



LONG TERM MODEL

	2015E	2016E	2017E	2018E	
Square Footage Growth	0.3%	0.2%	0.0%	0.0%	If anything, it goes negative.
Comp Store Sales	1.7%	1.7%	1.4%	0.6%	We're probably optimistic here.
e-Commerce	23%	20%	15%	15%	KSS' only growth engine.
Revenue Growth	2.0%	1.8%	1.4%	0.6%	\$19bn+ today. Might never see \$20bn.
Gross Margins	36.0%	35.7%	35.5%	35.2%	Long-term downtrend. e-comm dilution, Nat'l brand penetration, Y2Y 5% rebate
Gross Profit Growth	0.9%	1.1%	0.6%	-0.1%	
SG&A Growth	3.9%	3.0%	3.0%	3.0%	Can't keep costs down forever. Credit (~10% of SG&A) peaking out as an offset. Wage inflation 2H15.
D&A Growth	6.1%	2.0%	2.0%	2.0%	
EBIT Margin	7.9%	7.3%	6.7%	5.8%	Ditto for D&A after the 6.7% cut in '14.
EBIT Growth	-9.7%	-5.2%	-7.8%	-12.7%	
Interest	-1.2%	0.0%	0.0%	0.0%	Interest flat, as cash goes toward repo. But long-term repo is 1/2 of today's rate.
Shares Outstanding	-5.6%	-2.7%	-3.2%	-3.3%	
EPS	\$3.90	\$3.74	\$3.47	\$2.98	
EPS Growth	-8.5%	-4.1%	-7.2%	-14.1%	

EPS DOWNSIDE FROM CREDIT

RISK IS DISPROPORTIONATE TO DOWNSIDE

2016E	Bull	Base	Bear
Sales	+2.5%	1.0%	-3.0%
Credit Penetration	60%	55%	50%
Charge Offs	Flat	Flat	+350bps
Credit SG&A Offset	+3%	-7%	-34%
Non Credit EBIT Margin	+50bps	Flat	-100bps
Incremental EPS	\$0.46	-\$0.06	-\$1.22
% Change	10%	-1%	-27%

100 bps
increase in
charge off rate
has 1.5% EPS
impact



WHY CREDIT IS SO IMPORTANT

3-HEADED REWARDS PROGRAM



- Annual spend - \$0-\$600
- % of KSS Shoppers – **20.5%**
- Benefits
 - 12 sales events/year
 - Advance Sales Notification



- Annual spend - \$601+
- % of KSS shoppers – **11.2%**
- Benefits
 - 12 sales event/year
 - 6 pick-a-day offers
- Additional discounts in specific departments



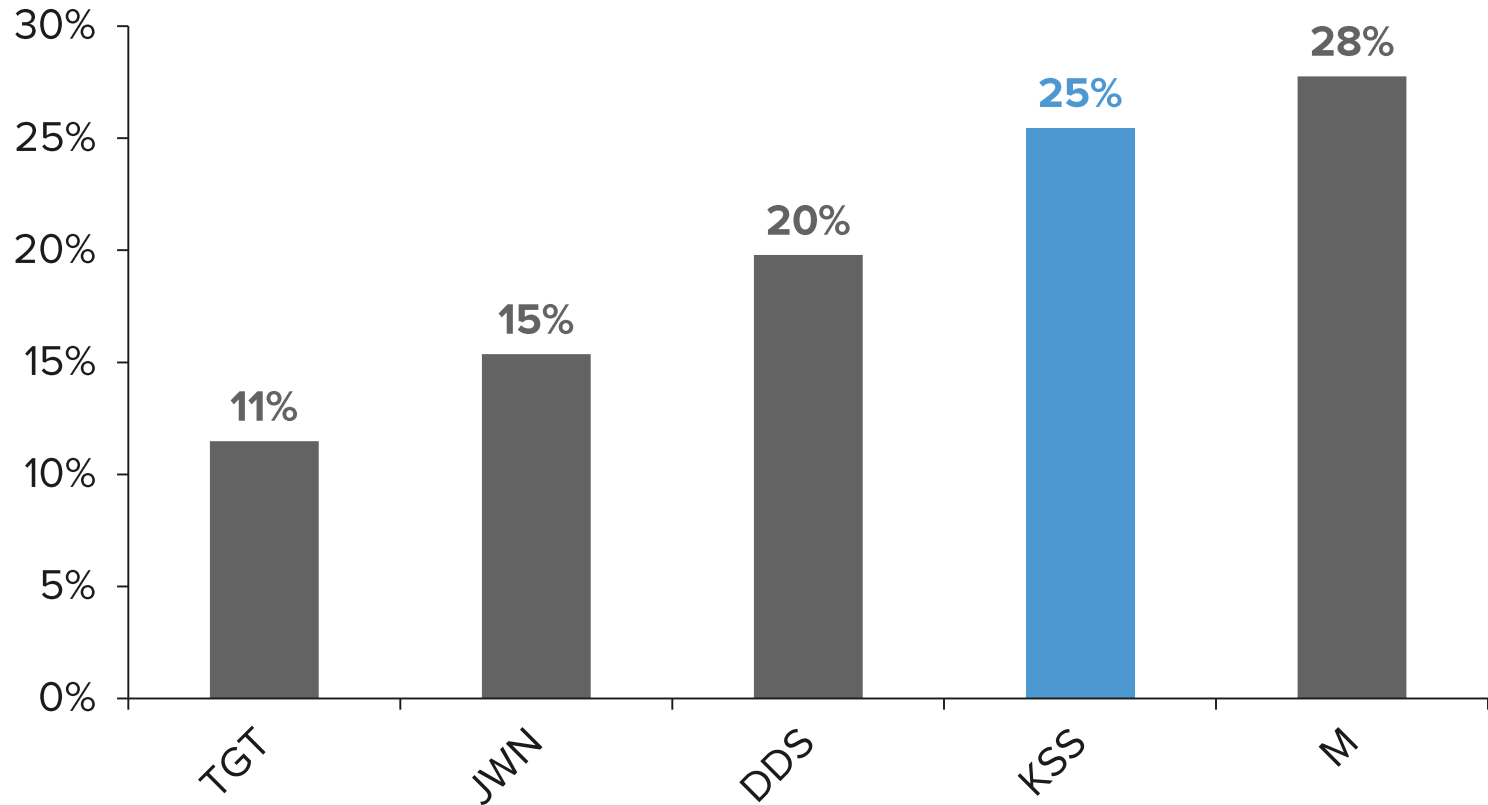
- Tender agnostic
- % of KSS Shoppers – **40.8%**
- Benefits
 - 5% KSS rewards rebate
 - 8 offers/year, + 1 additional birthday offer



- Tender agnostic
- Bi-monthly earning and redemption periods
- Benefits
 - \$10 in Kohl's Cash for every \$50 spent
 - 10-15 day redemption window

CREDIT % OF EBIT -- COMPARABLES

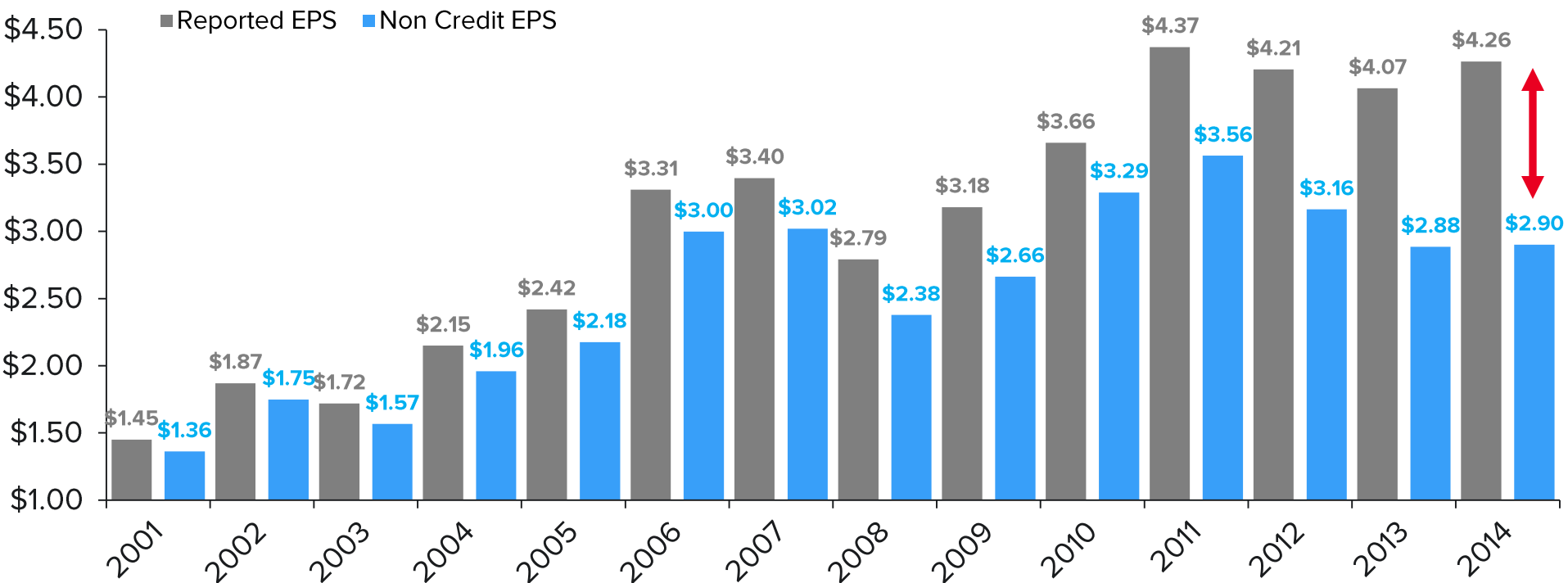
CREDIT CARD AS % OF EBIT



Macy's credit exposure is slightly higher than KSS.

But KSS is the only one with tangible risk to the downside.

BIGGEST GROWTH DRIVER -- EVER

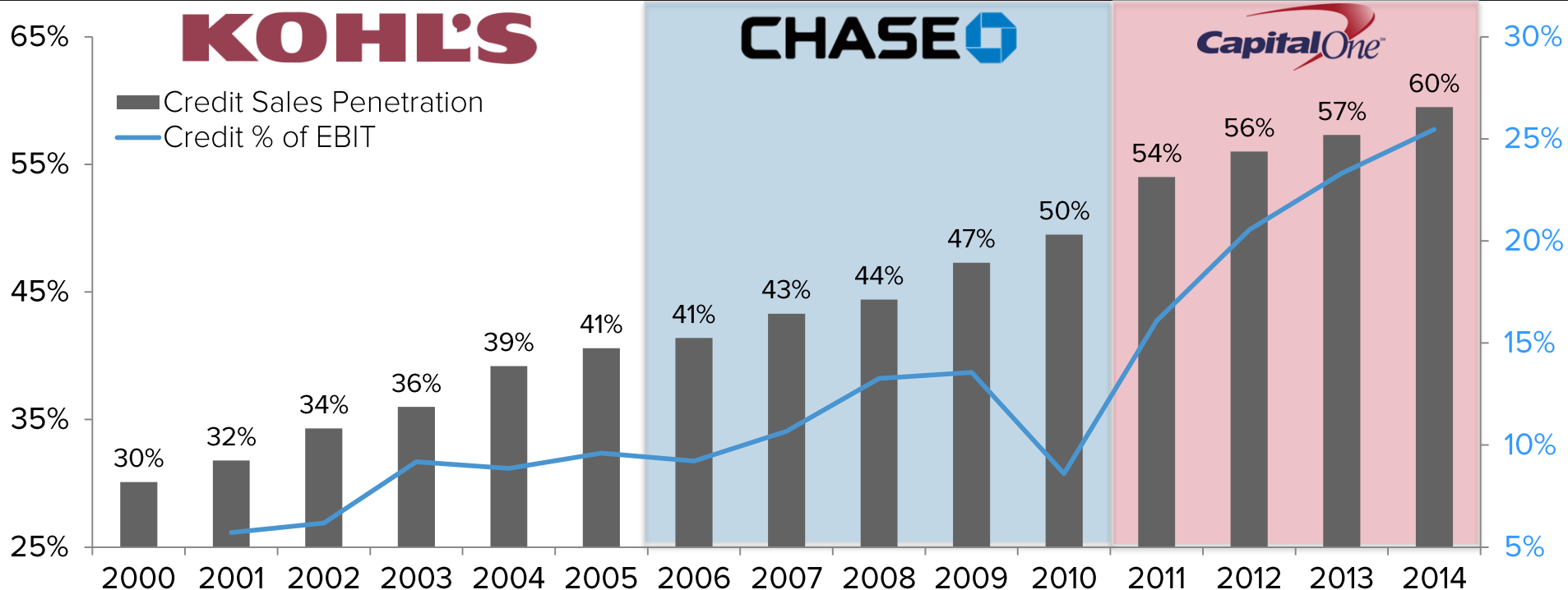


REPORTED EPS VS EPS EXCLUDING CREDIT INCOME

Note that the 'excluding credit' earnings stream still includes the sales generated from the credit card (as it should) but simply not the finance income as it has accrued to KSS.

HISTORICAL CONTEXT IS
CRITICAL
TO UNDERSTANDING RISK

KSS CREDIT – A 15 YEAR LOOK BACK

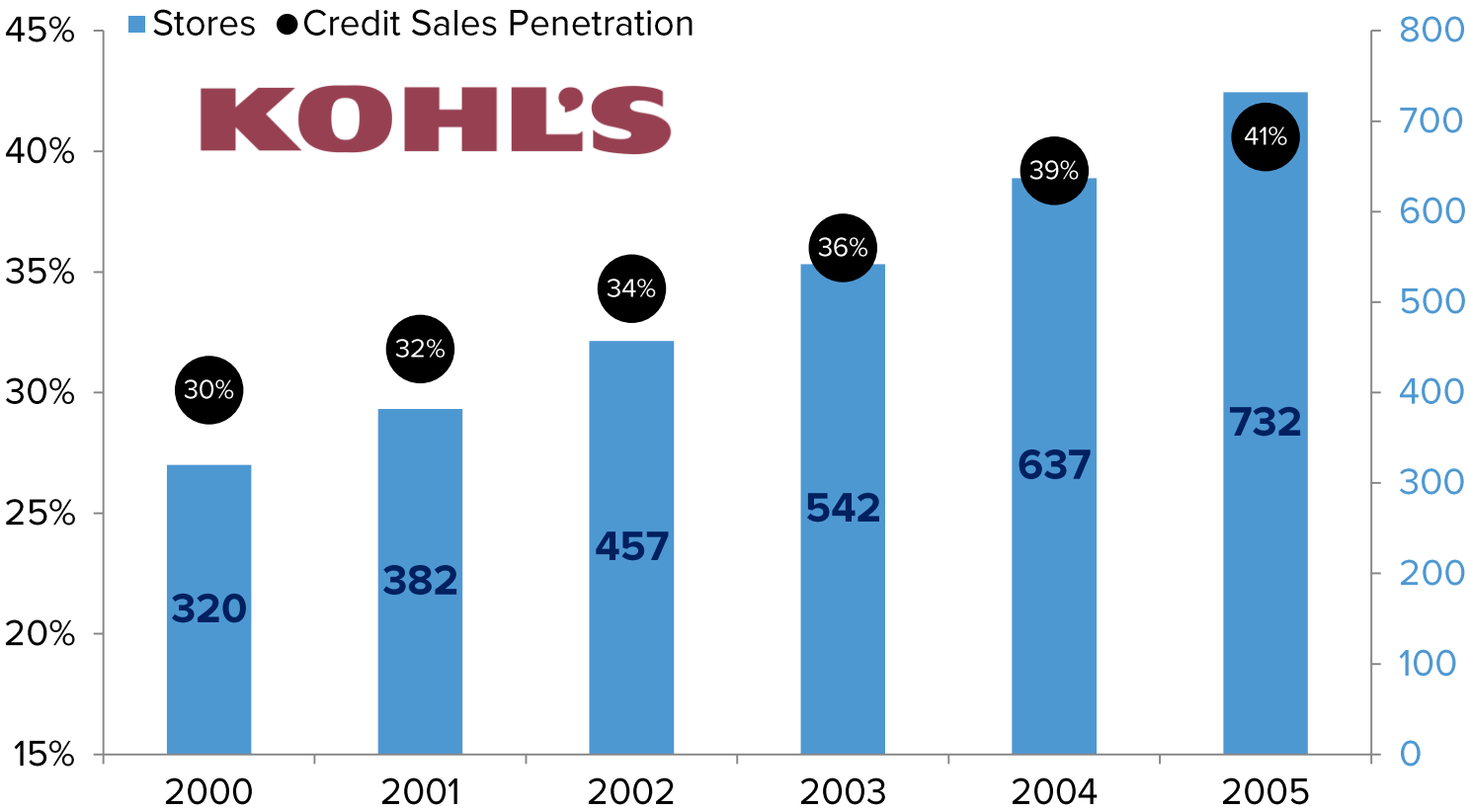


3 CREDIT OPERATIONS, 3 GROWTH PHASES, ONE MEANINGFUL SG&A TAILWIND

There are 3 different credit operations over 3 different periods of growth for KSS.
Net revenues from the credit operation are booked as an SG&A offset.

STAGE 1: SELF-FUNDED GROWTH

KSS-OWNED 2000-2005



Store Growth:
19% CAGR

Credit Penetration:
30% --> 41%

Credit % of EBIT:
6% --> 10%

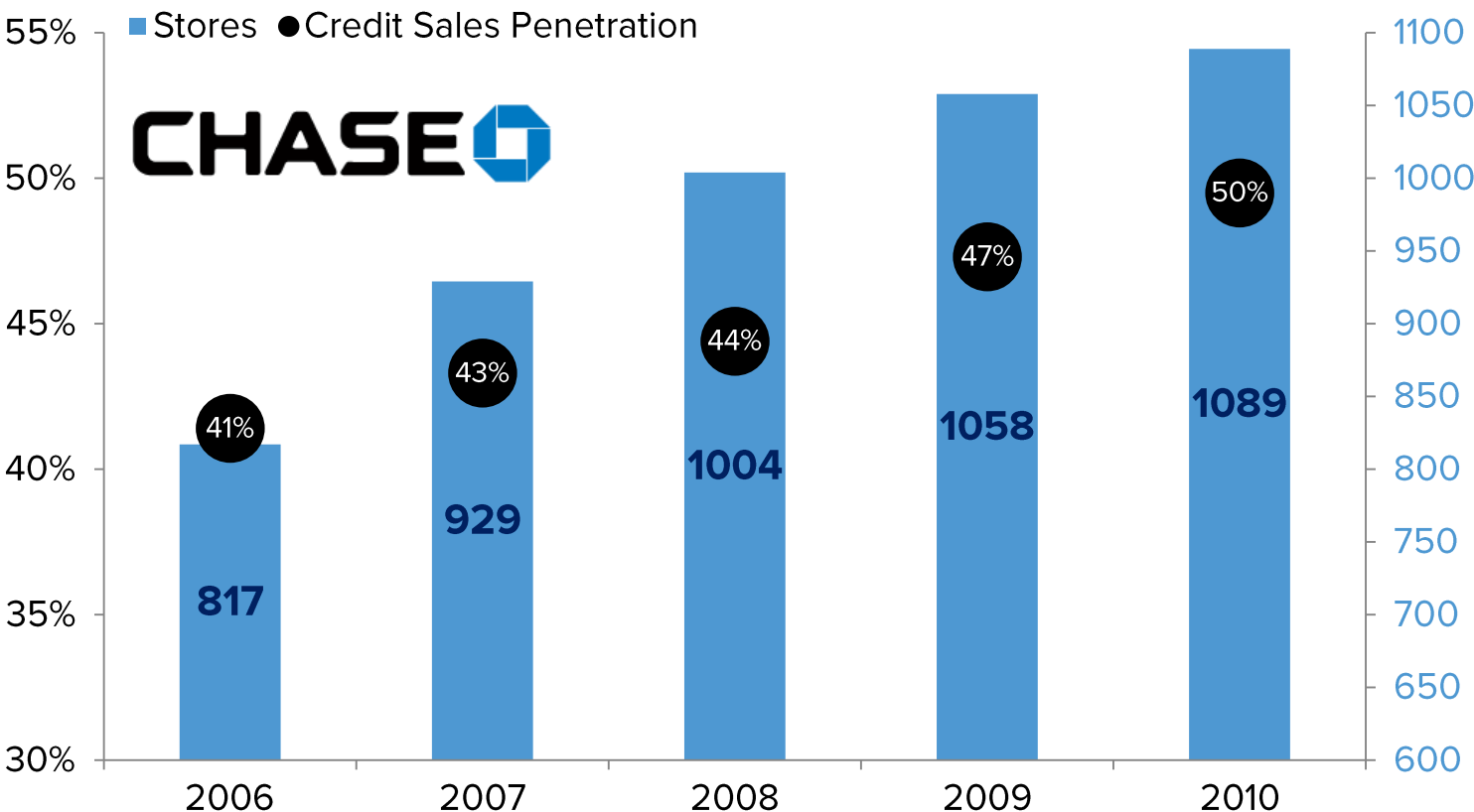
In 2006 KSS Sells
Credit Portfolio to JP
Morgan Chase.

Kohl's also had a
receivables
purchase
agreement from
1999-2006

*Kohl's operated credit card starting
1995 after ending Citi agreement

STAGE 2: FOOTPRINT EXPANSION

KOHL'S PARTNERED WITH CHASE 2006-2010



In '06 - KSS Sells Credit Portfolio to JPM Chase
Median Fico Score **700-750**.

Store Growth:
8% CAGR

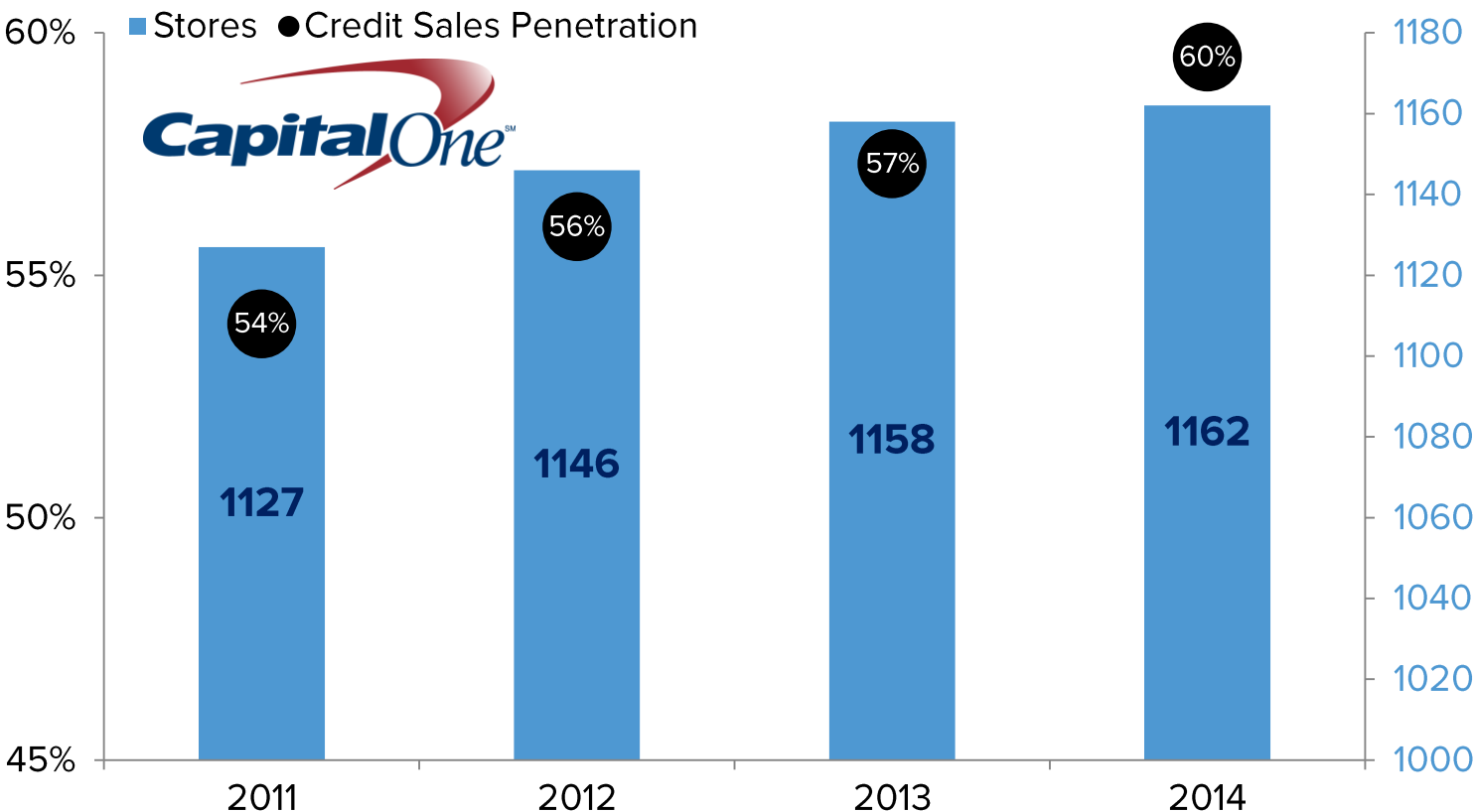
Credit Penetration:
41% → 50%
Credit % of EBIT:
10% → 14%

Chase takes KSS through recession, and to near completion of footprint growth.

In 2011 - Credit portfolio hits Chase's risk tolerance

STAGE 3: FILL-IN GROWTH

KOHL'S PARTNERED WITH CAPITAL ONE 2011-PRESENT



CapOne taps more marginal consumers.

Median FICO Score 600-650

Minimal Store Growth:
2% CAGR

Credit Penetration:
50% → 60%

Credit % of EBIT:
14% → 25%

Portfolio hits Cap One's
risk tolerance in '14

In 2014, Rewards is
decouple with credit
card (Yes2You)

WHY DECOUPLE?

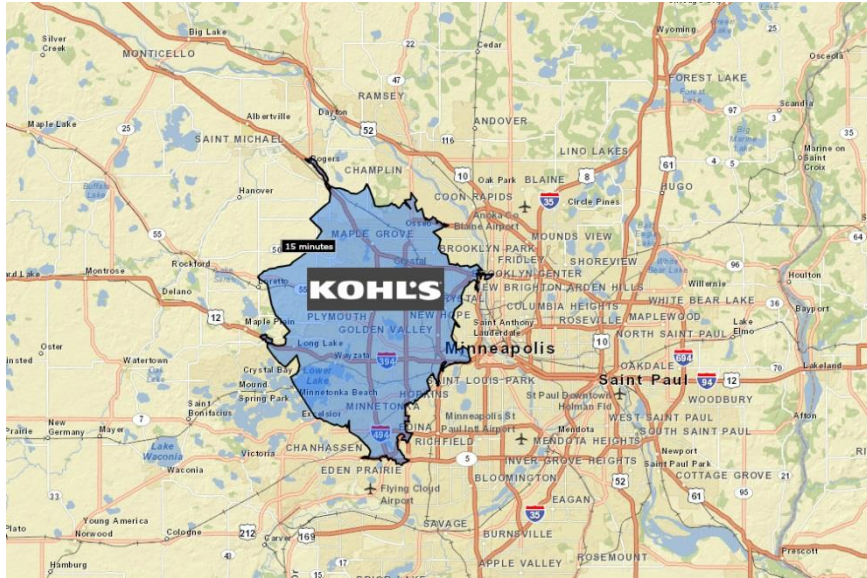
ARE THERE ANY CUSTOMERS TO BE FOUND?

KOHL'S CUSTOMER PENETRATION

	TARGETED AGE RANGE		
	30-60 yrs	61-80 Yrs	Total
Total US Population (mm)	126.9	52.9	179.8
Female	64.7	27.0	91.7
Male	62.2	25.9	88.1
	30-60 yrs	61-80 Yrs	Total
Adjusted Target Market			
Female (75% = KSS Potential Market)	48.5	20.2	68.8
Male (15% = Potential Market)	9.3	3.9	13.2
Total in Core Demo	57.9	24.1	82.0
KSS Customers			63.4
Customer Penetration			77.3%

Kohl's is already over 75% penetrated into its potential customer base.

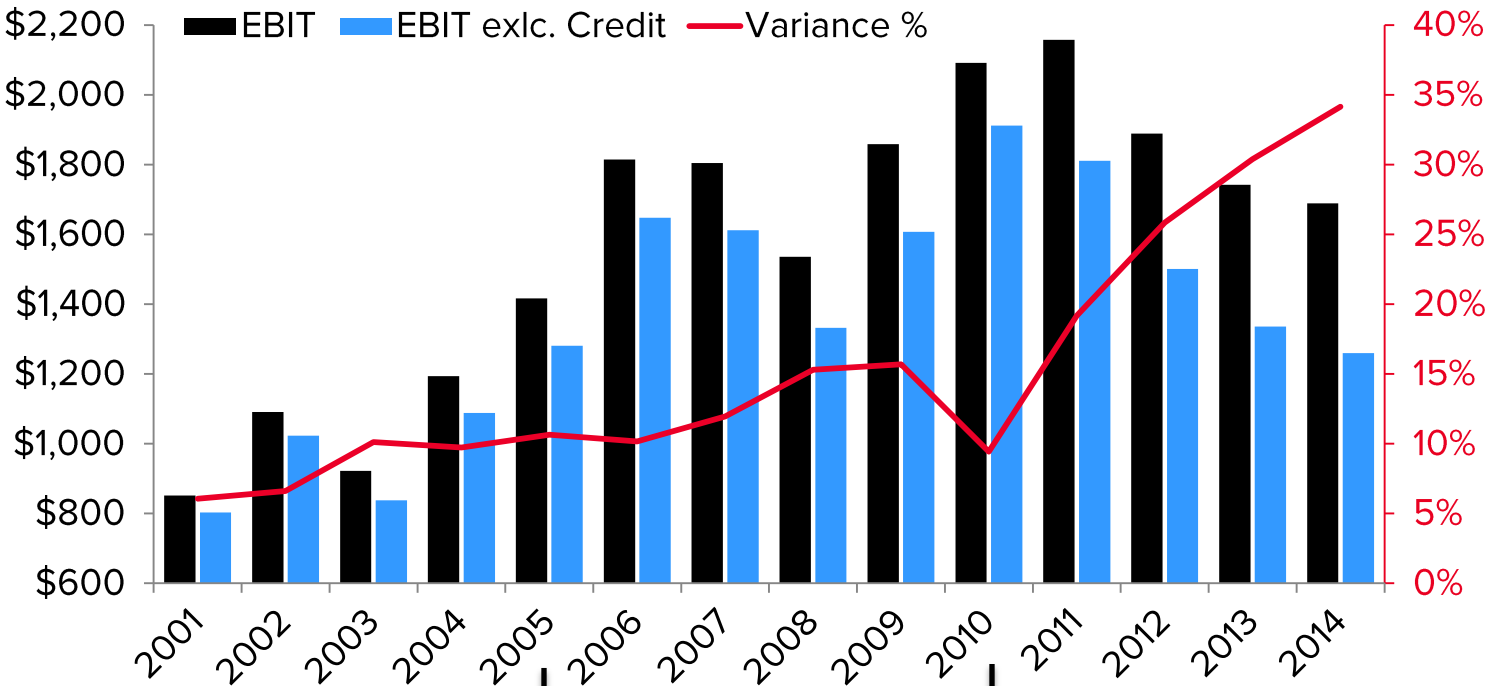
METHOD #2 = SAME RESULT



Total Stores	1162
Avg. HHs w/in 15 min drive of KSS location	72,000
Total Revenue (mm)	19,023
Avg. Basket	\$75
Transactions (000)	253,640
Transactions/consumer	4.0
Customers (000)	63,410
Per Avg Store	54,570
HOUSEHOLD SHARE	
Potential Customers Per Avg Mkt	72,000
Realized Customers Per Mkt	54,570
Household Share	75.8%

CREDIT VEILS THE TRUE TREND

EBIT EXCLUDING CREDIT BENEFIT



Including Credit EBIT was down 9.1% over the past 5 years.

Excluding Credit it is down 21.7% over 5 years.

*Kohl's also had a receivables purchase agreement from 1999-2006

KOHL'S

CHASE

CapitalOne

CREDIT CHARGE-OFF RISK BOTTLING

100 LARGEST BANKS CC CHARGE-OFF RATES



Credit charge-off rates at 30 year lows.

NO MATTER



CREDIT SURVEY DETAIL

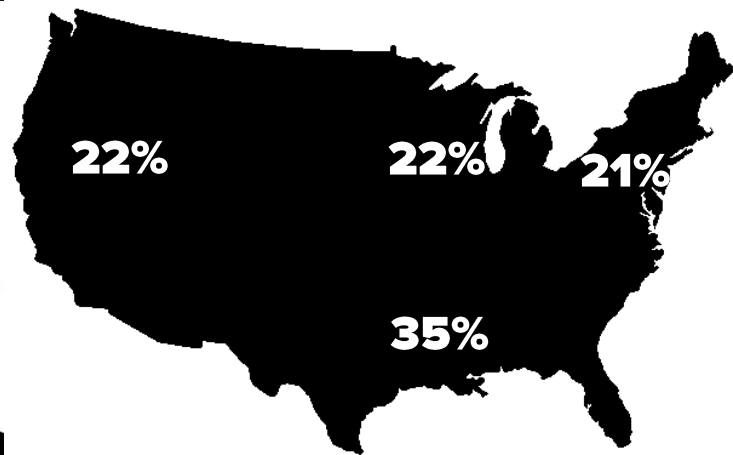
HERE'S WHO WE SURVEYED – 1,000

94% SHOP AT **KOHL'S**

Household Income	
< \$25K	18%
\$25K-\$39K	18%
\$40K-\$49K	11%
\$50K-\$74K	23%
\$75K-\$99K	14%
\$100K-\$124K	7%
\$125K-\$149K	4%
\$150K+	6%



Female 52% Male 48%



No Rewards

48%

YES2YOU
REWARDS

39%



34%

KSS SHOPPER BREAKDOWN

Rewards Memberships

% of Customers

Est. % of Sales



+

YES2YOU™
R E W A R D S

25%

50%



Only

8%

10%

YES2YOU™
R E W A R D S

Only

16%

15%

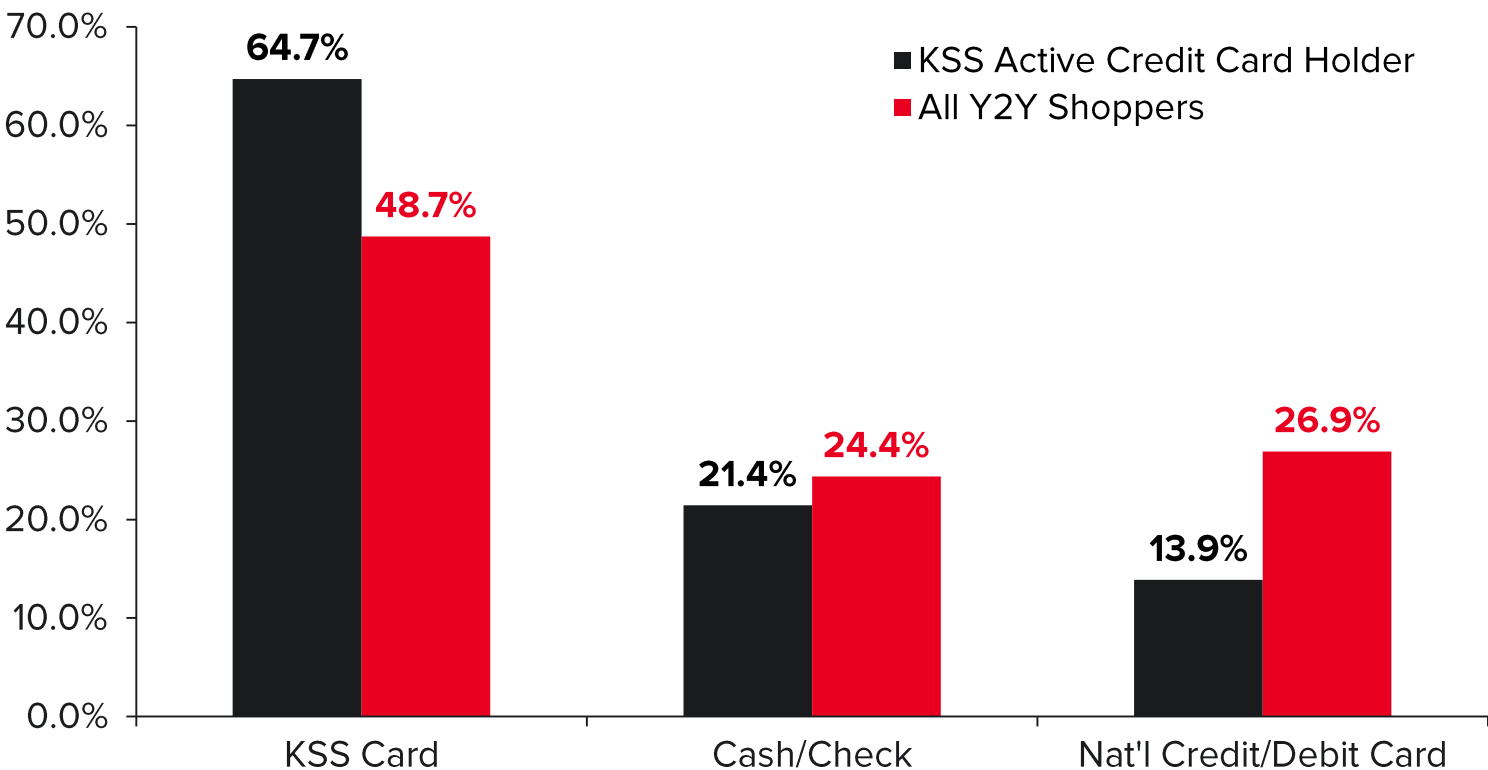
No Rewards

51%

25%

PAYMENT PATTERNS ARE DIFFERENT

Y2Y/KSS CREDIT CARD HOLDERS REPORTED TENDER USAGE

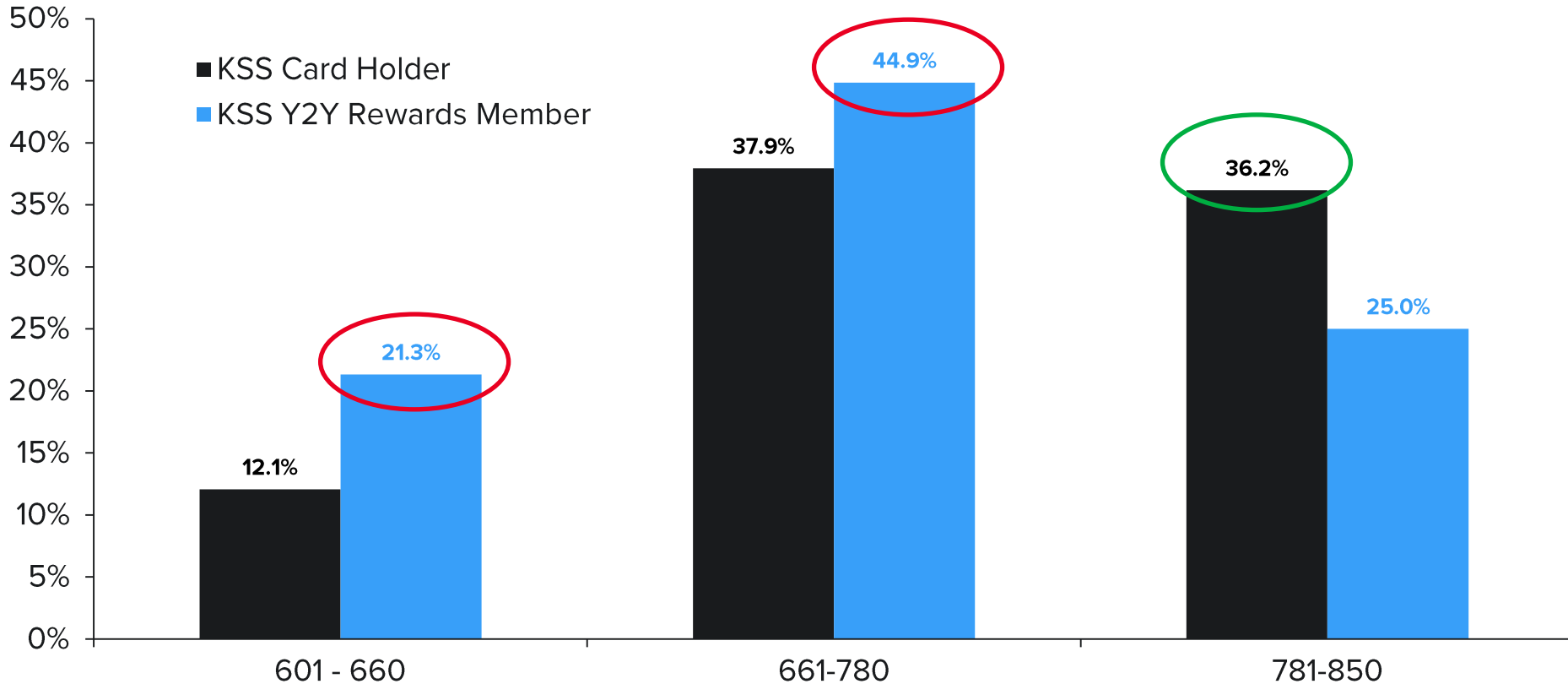


This shows that the percent of Y2Y members paying with a Kohl's card is 16 points below 'Kohl's Card-Only'.

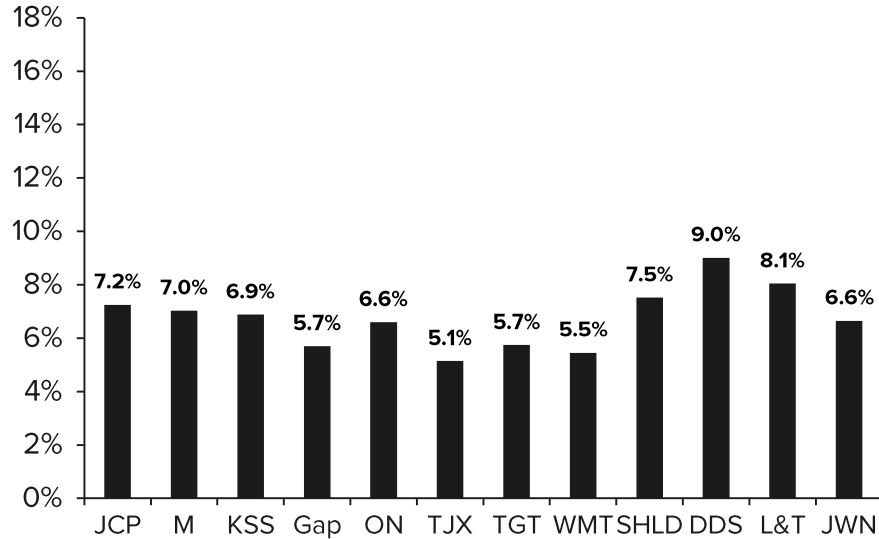
There's a 3 point higher Cash/Check rate, and 13 point Nat'l Credit Card usage rate.

Y2Y SKEWS TO LOWER INCOME

FICO CREDIT SCORE DISTRIBUTION



BAD CREDIT? NO PROBLEM.



14.7%

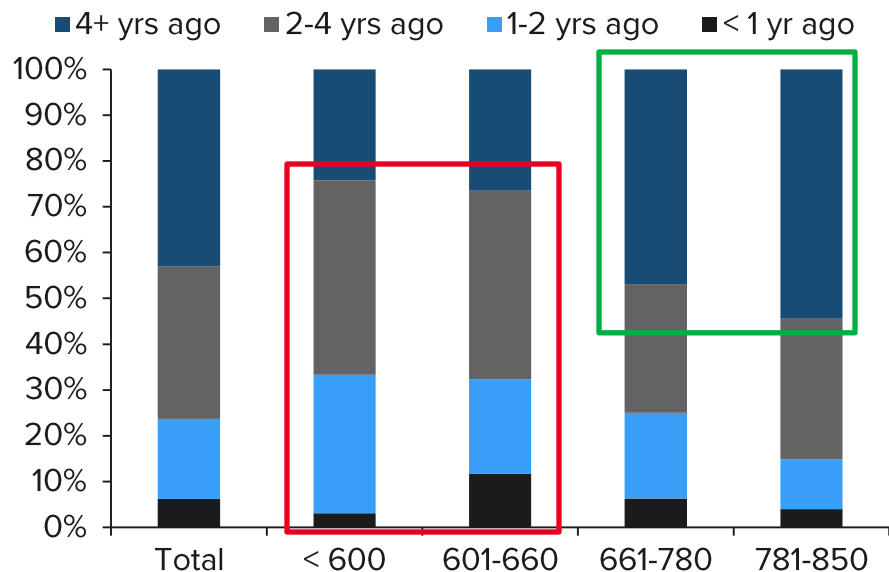
CARD DENIAL RATES

Card denial rates are fairly uniform across retailers for customers looking for a new card.

YES2YOU REWARDS MEMBERS

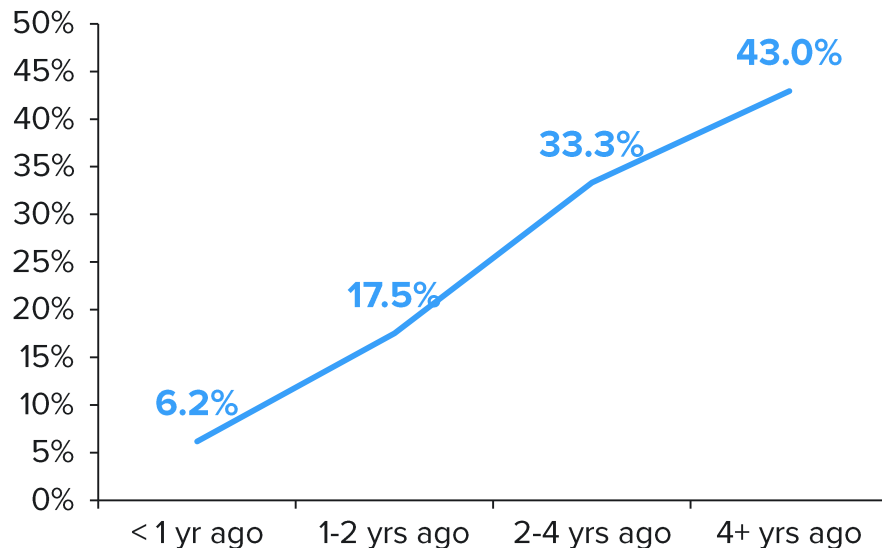
14.7%...that's the % of Y2Y members we surveyed were denied a Kohl's Capital One credit card due to poor credit in the past year. This is KSS' way of getting lower quality consumers into the store.

CREDIT QUALITY IS DETERIORATING



CREDIT CARD ISSUANCE BY YEAR/FICO

The highest quality FICO scores are associated with cards issued 4+ yrs ago, and to a lesser degree, 2-4 years ago. Cards issued in the past 1-2 years are for lower credit-quality consumers.

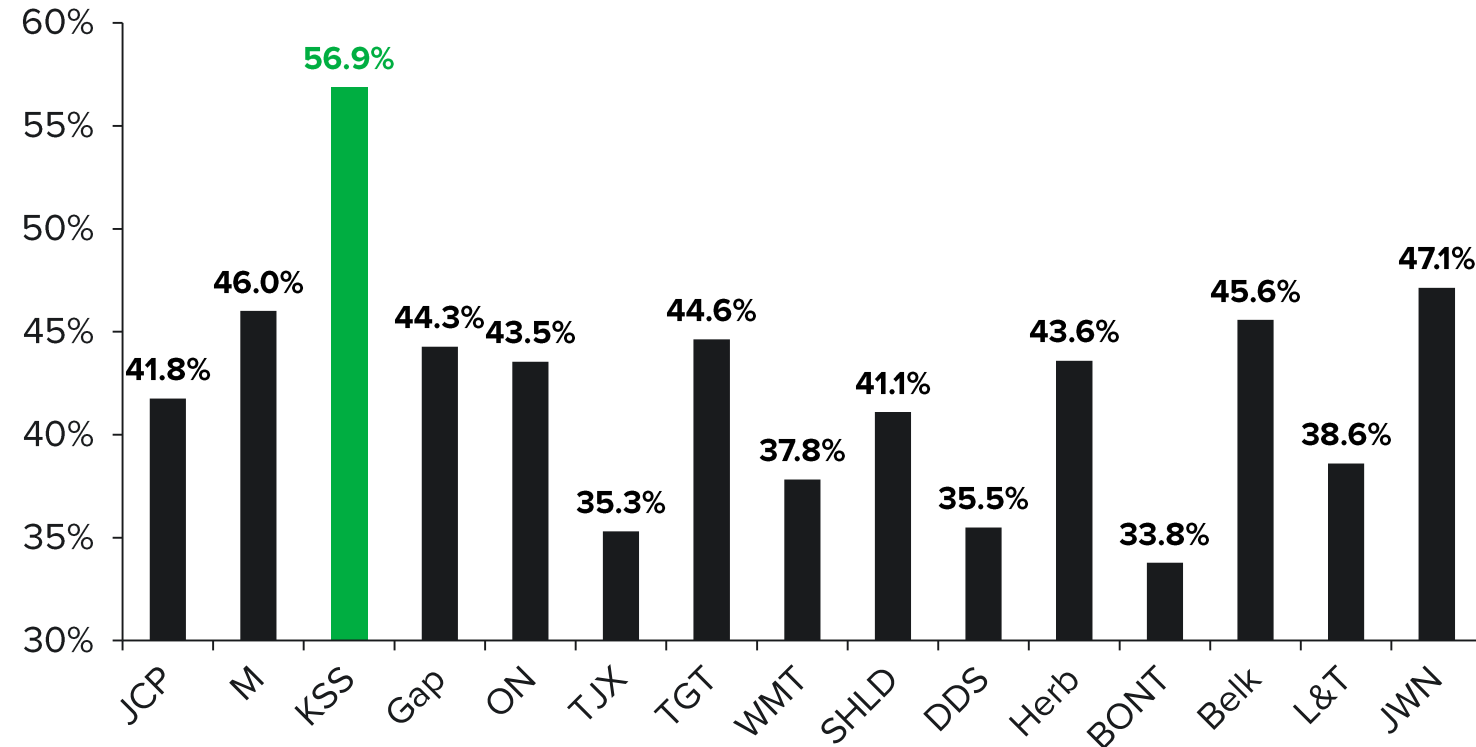


CARD HOLDER ISSUANCE SLOPE

This shows the percent of current cards by year issued. The key is that the 1-year number (6.2%) is far less than the 1-2 year number. In other words, new card issuance has slowed.

KSS IS OVERINDEXED TO CREDIT

CARD HOLDERS % OF PURCHASES ON CARD

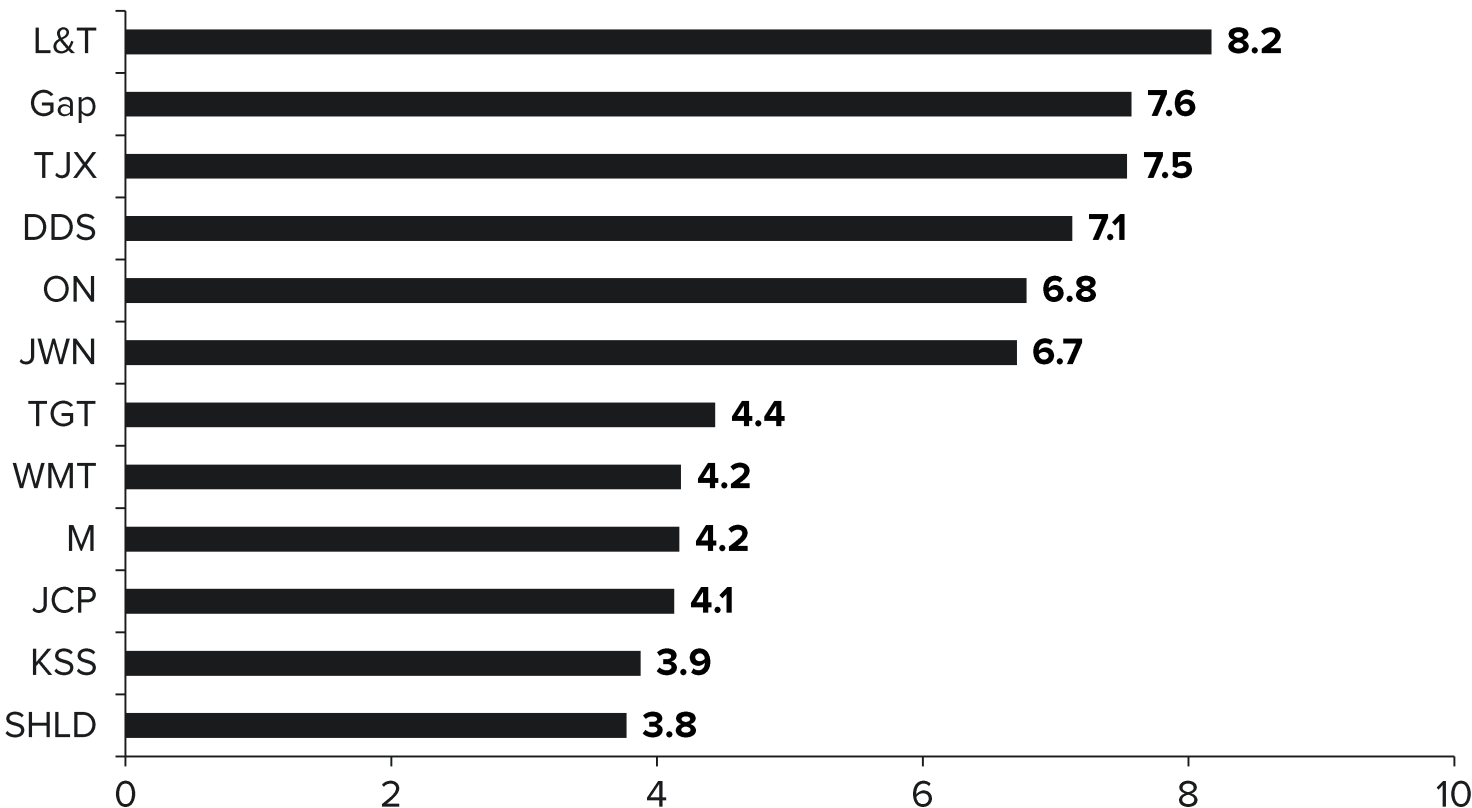


According to our survey, 56.9% of KSS shoppers use the Kohl's/Capital One card.

That's 15 points higher than the industry average.

WHAT'S IN YOUR WALLET?

AVERAGE # OF APPAREL/DEPT. STORE CREDIT CARDS

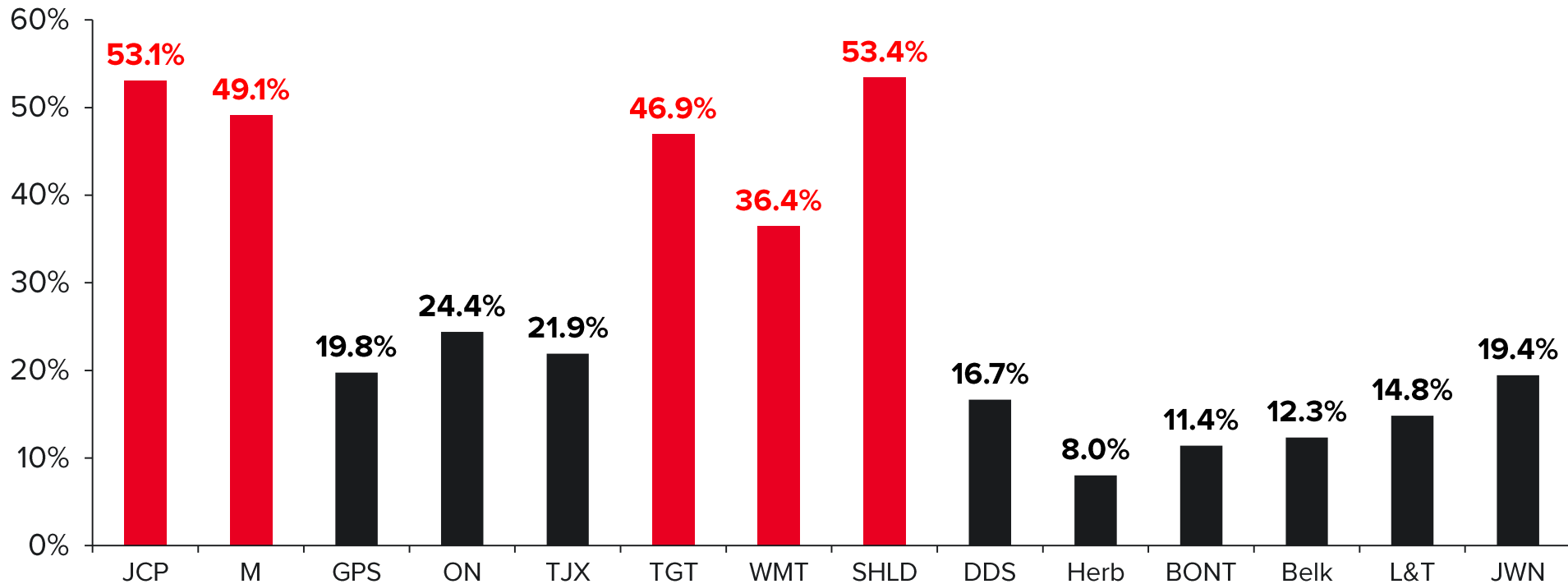


Perhaps a bullish factor. Those who have a KSS card have only 3.9 such cards in their wallet.

More loyal?

Or can't afford better?

CARD OVERLAP

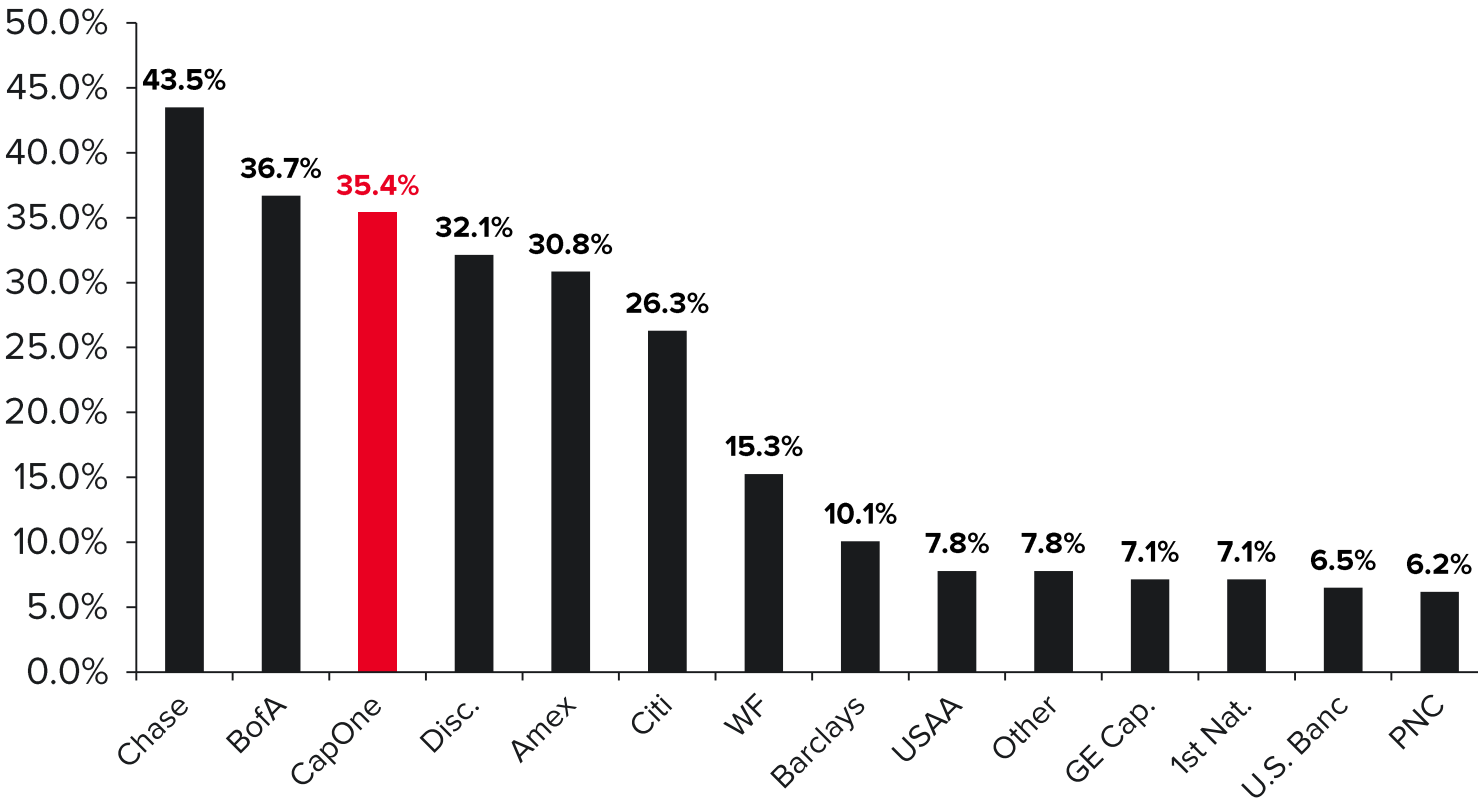


KSS CARD HOLDERS WHO ALSO CARRY COMPETING CARDS

JCP, TGT, WMT and SHLD all make sense. Macy's on the fringe.

COF'S DOUBLE DIP

NAT'L CARD OVERLAP

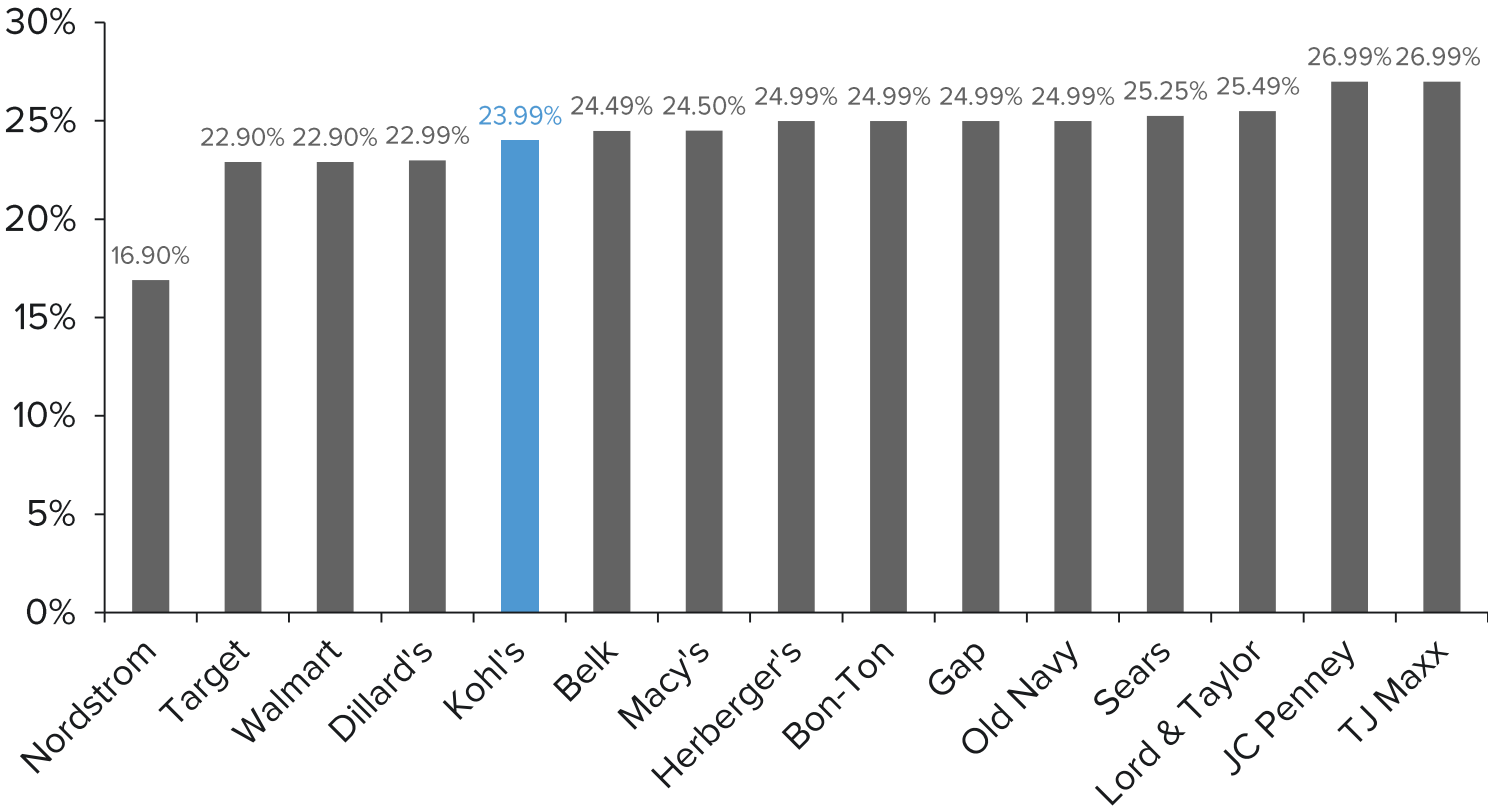


35.4% of Kohl's Card holders also have a separate Capital One card.

Interesting that 31% of KSS card holders carry an Amex.

EXPENSIVE MONEY

APRS FOR STORE CREDIT CARDS

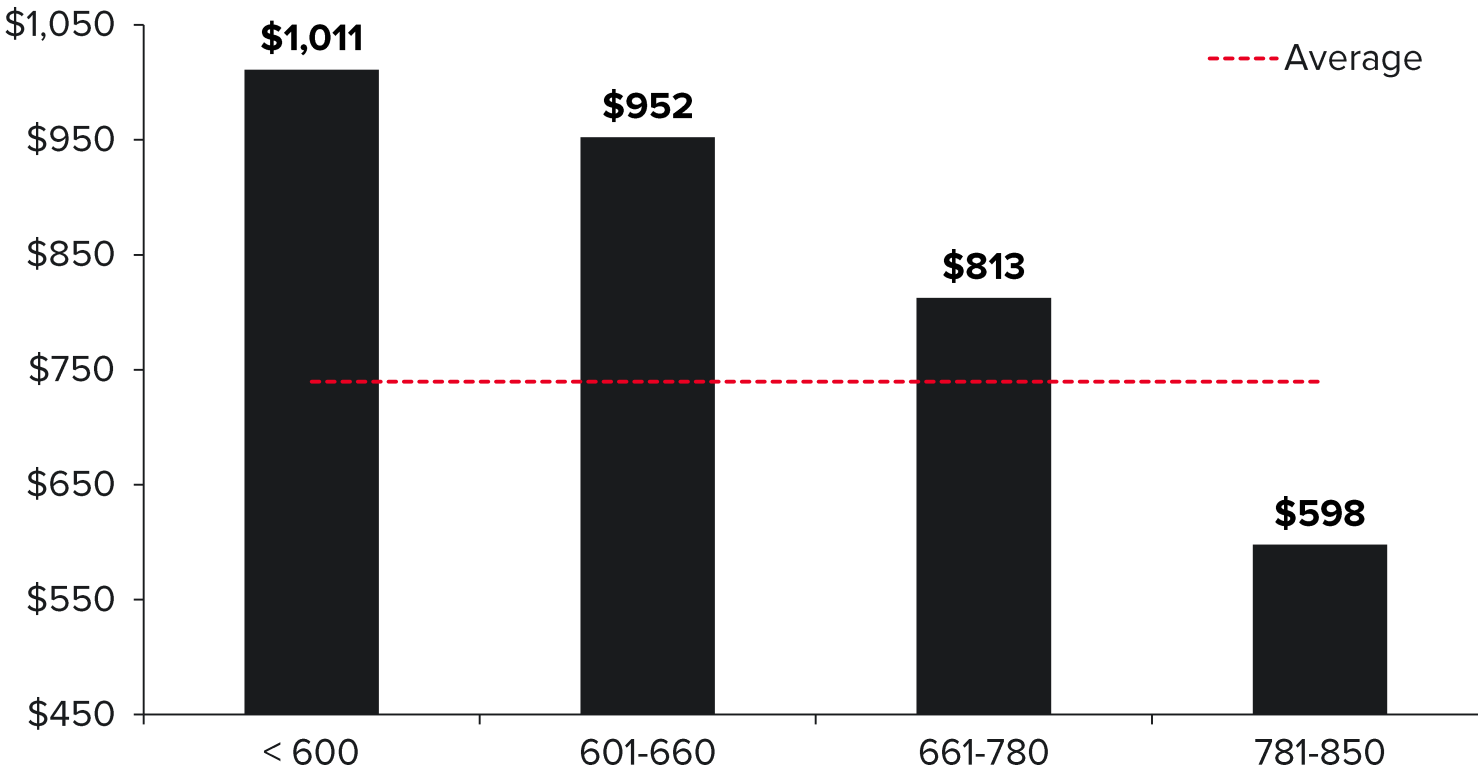


**Nordstrom uses tiered rates based on creditworthiness ranging from 7.9% to 22.9%

14 Retailers are within 400bps of one another. All are 22.9% or higher.

UNDESIRABLE CUSTOMER CURVE

AVG. ANNUAL SPENDING ON KSS CARD BY FICO SCORE

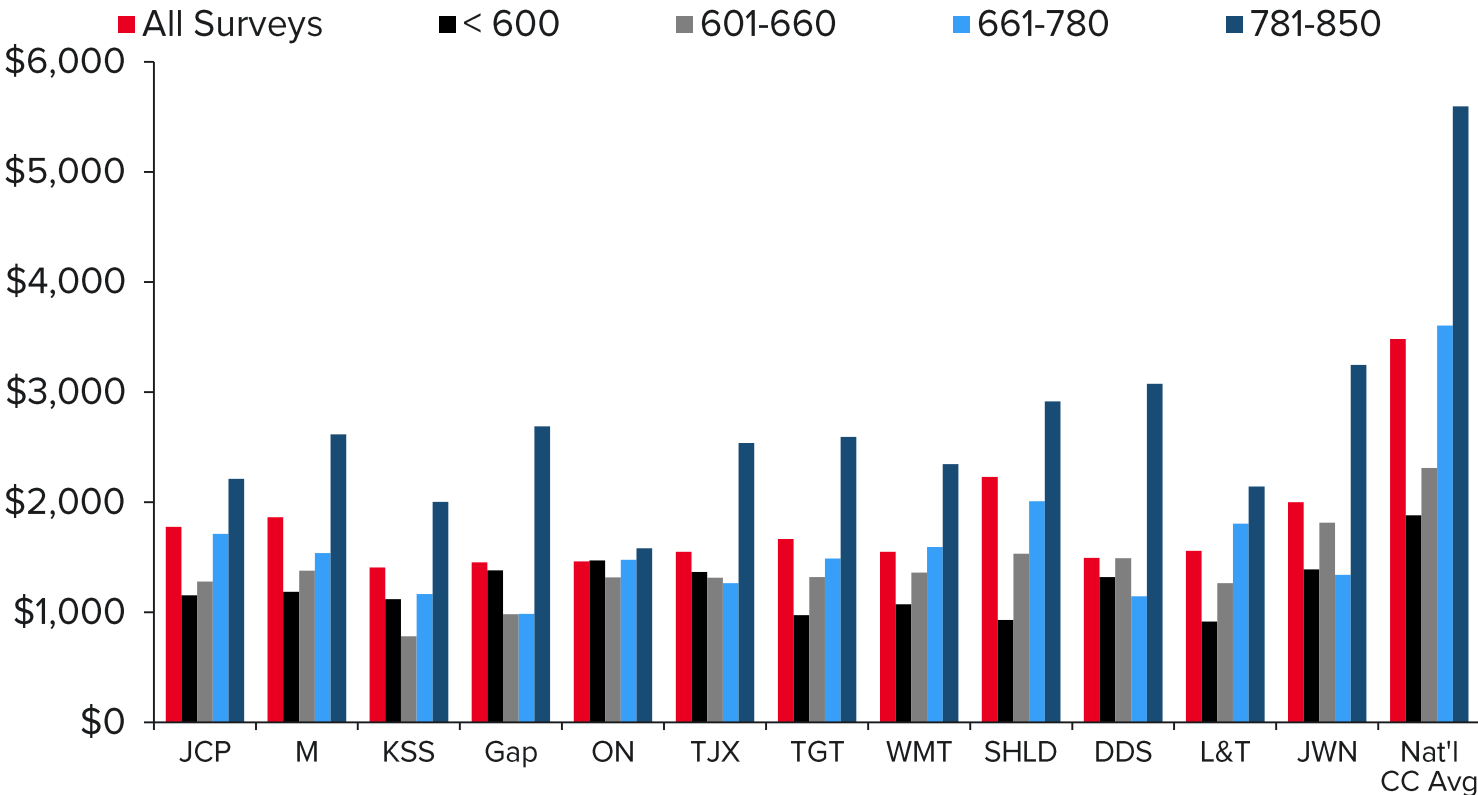


Higher the credit score, the lower the spending.

When dollar amounts go up, it accrues to the national cards like Amex, Citi

LOWER HIGHS AND LOWER LOWS

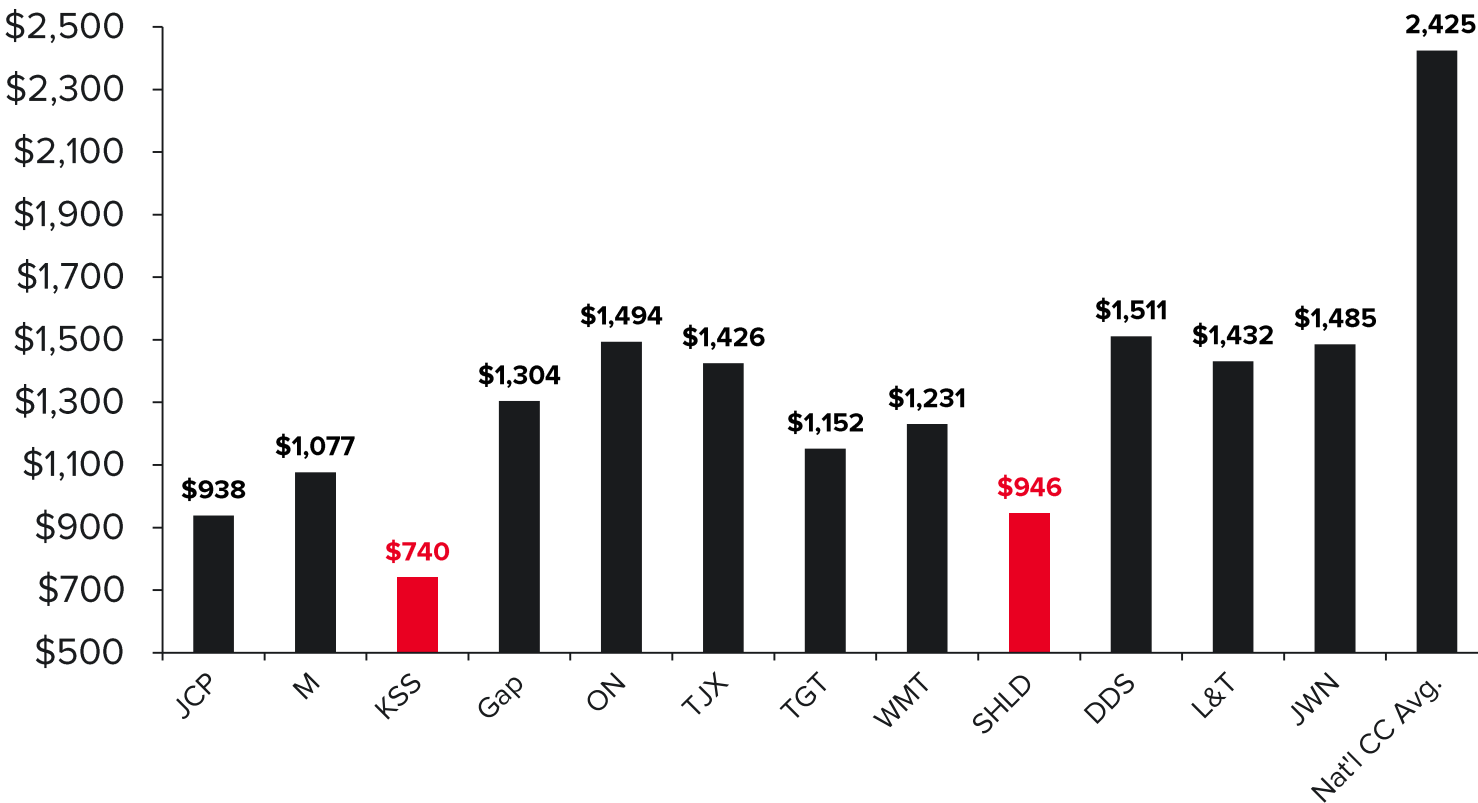
CUSTOMER CREDIT LIMIT PERCEPTION



KSS Customer perception of their credit limit ranges from \$750 to \$2,000.

SMALLEST SPEND, BY FAR

AVG. SPEND IN LAST 12 MONTHS ON CREDIT CARD

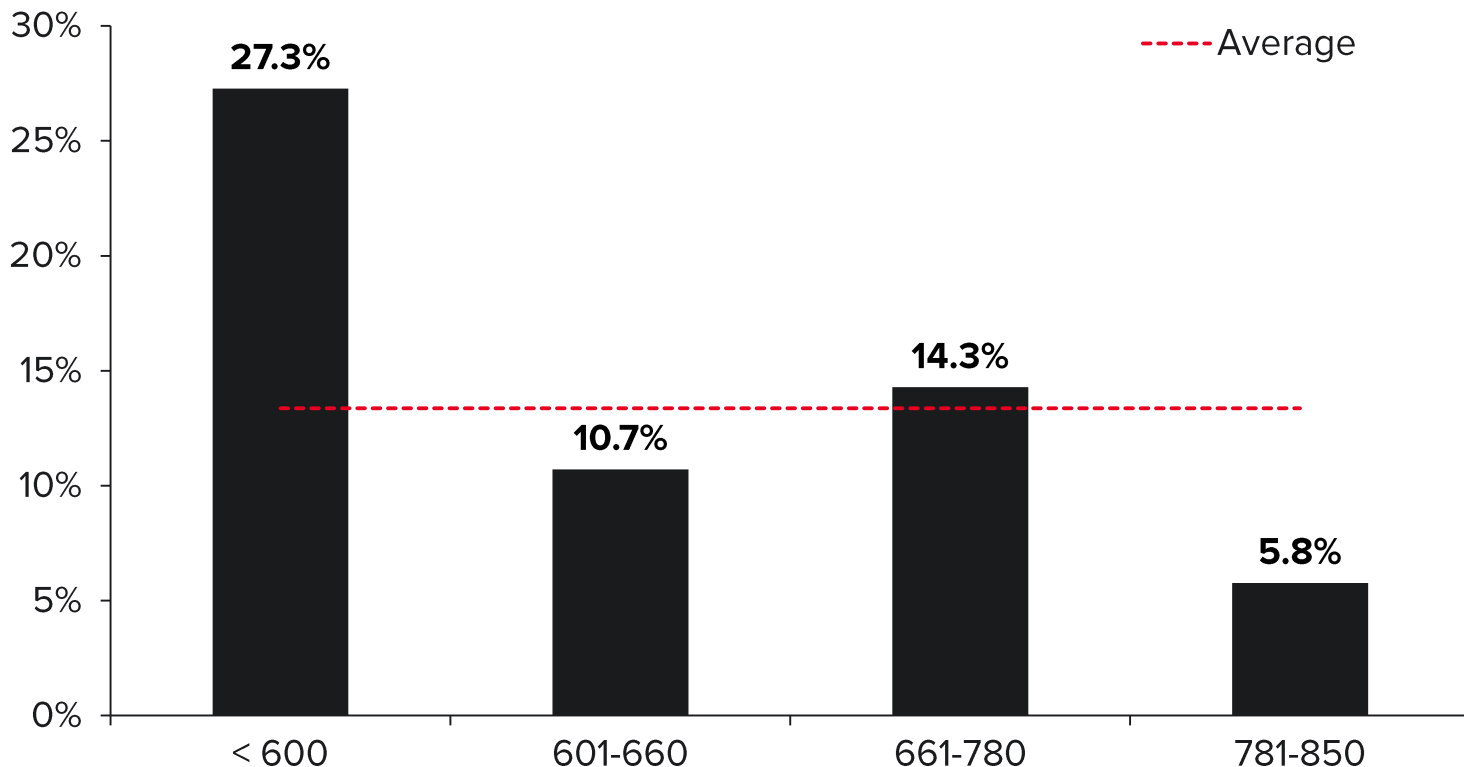


At \$740 last year, KSS was 20% below Sears, the only other retailer to clock in a number in the sub-\$1000 range.

WOULD SPEND MORE, BUT CAN'T

WHAT REASON(S) BEST DESCRIBE WHY YOU DON'T USE YOUR KOHL'S CREDIT CARD 100% OF THE TIME WHEN MAKING PURCHASES AT THE FOLLOWING RETAILER(S)? – **AT MY CREDIT LIMIT**

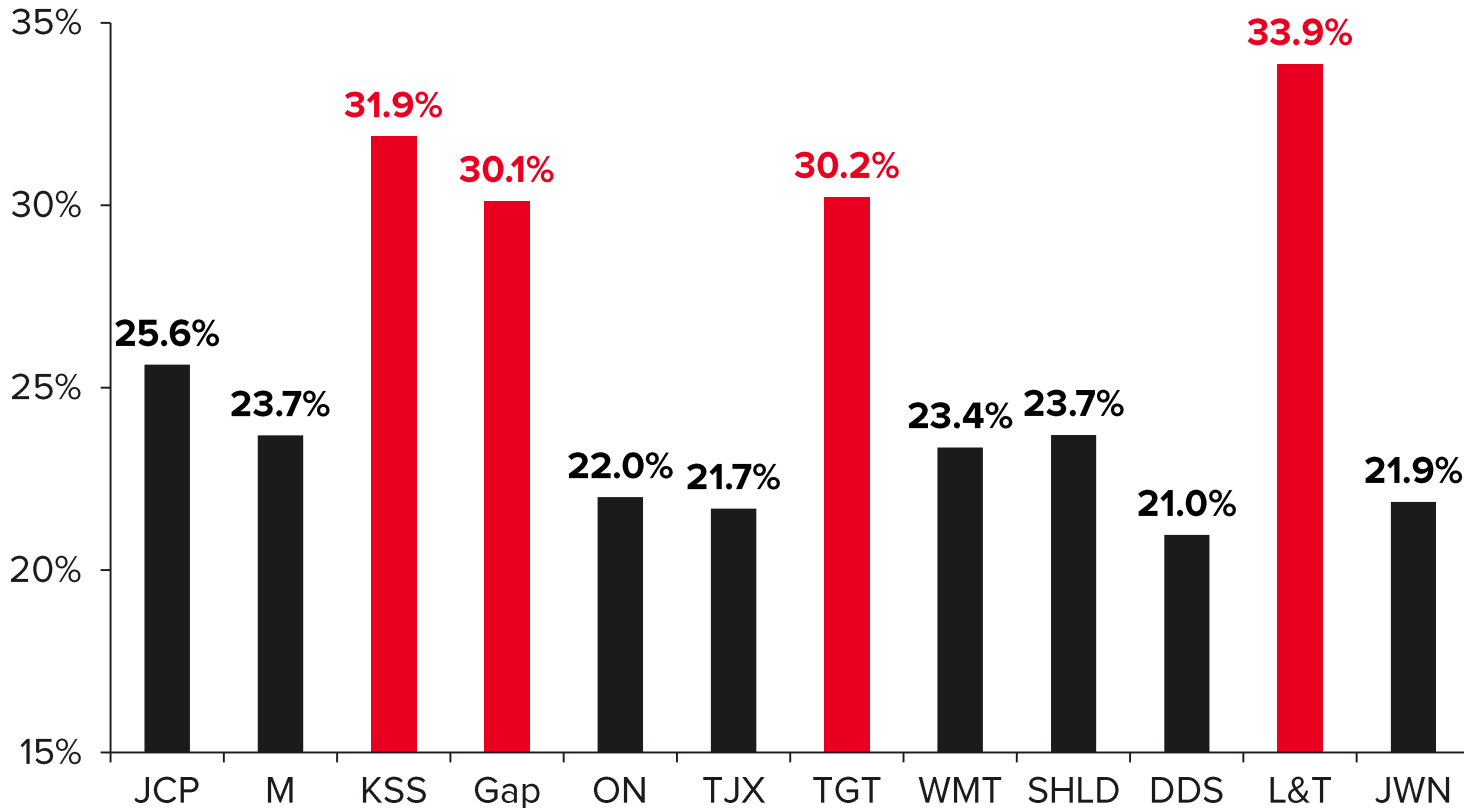
14% of people who do not use their card 100% of the time say that it is because they are at their credit limit.



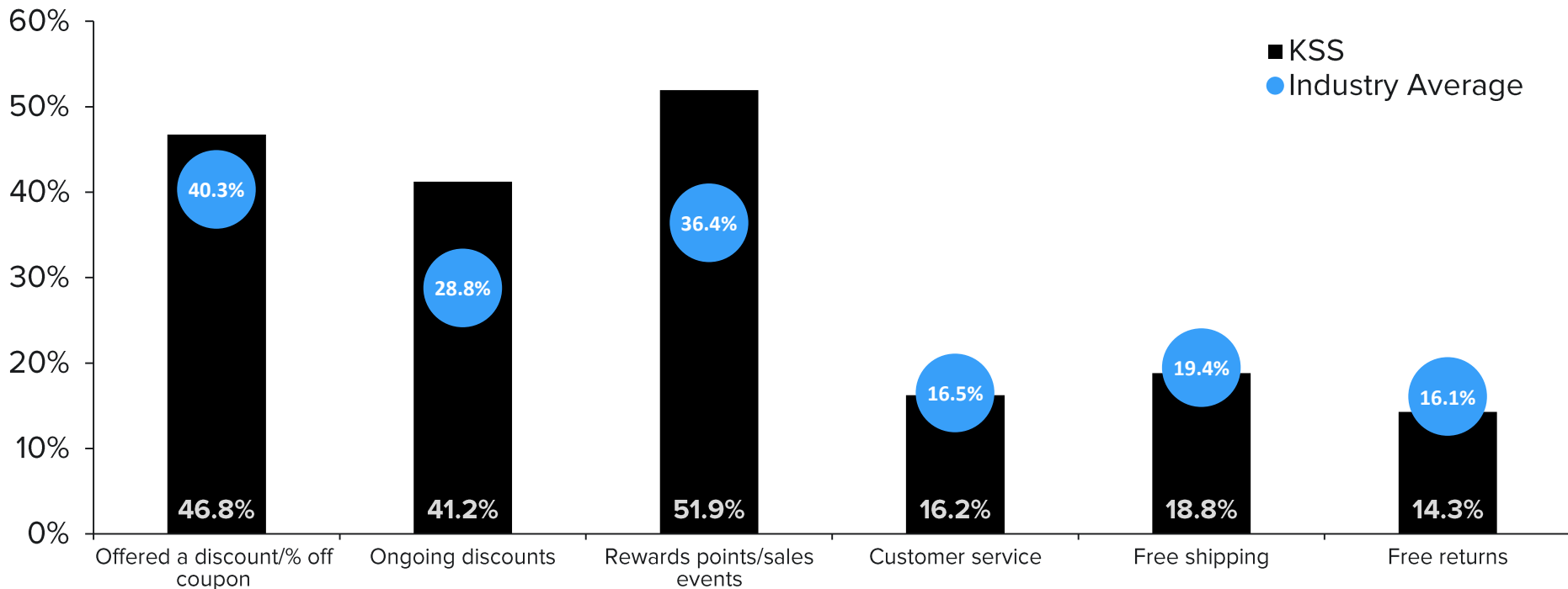
IMPORTANCE OF CREDIT, BY RETAILER

IF THE FOLLOWING RETAILERS DID NOT OFFER A CREDIT CARD WOULD YOU SPEND...?

Lord & Taylor, Kohl's, Gap and Target all scored the worst by customers indicating that they would spend significantly less at the store without a credit program.



REASONS FOR SIGNING UP FOR CREDIT

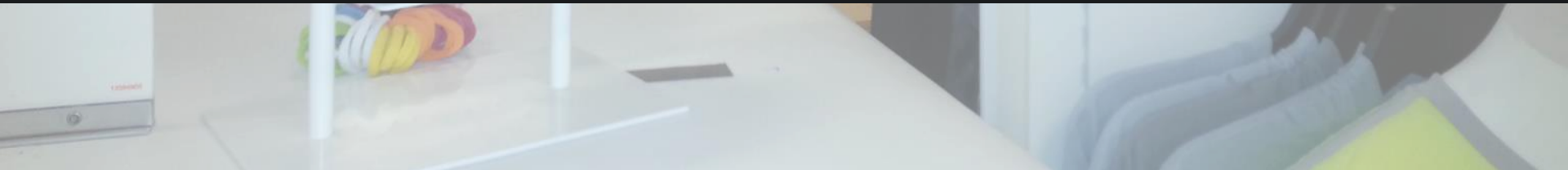


WHY SIGN UP FOR CREDIT?

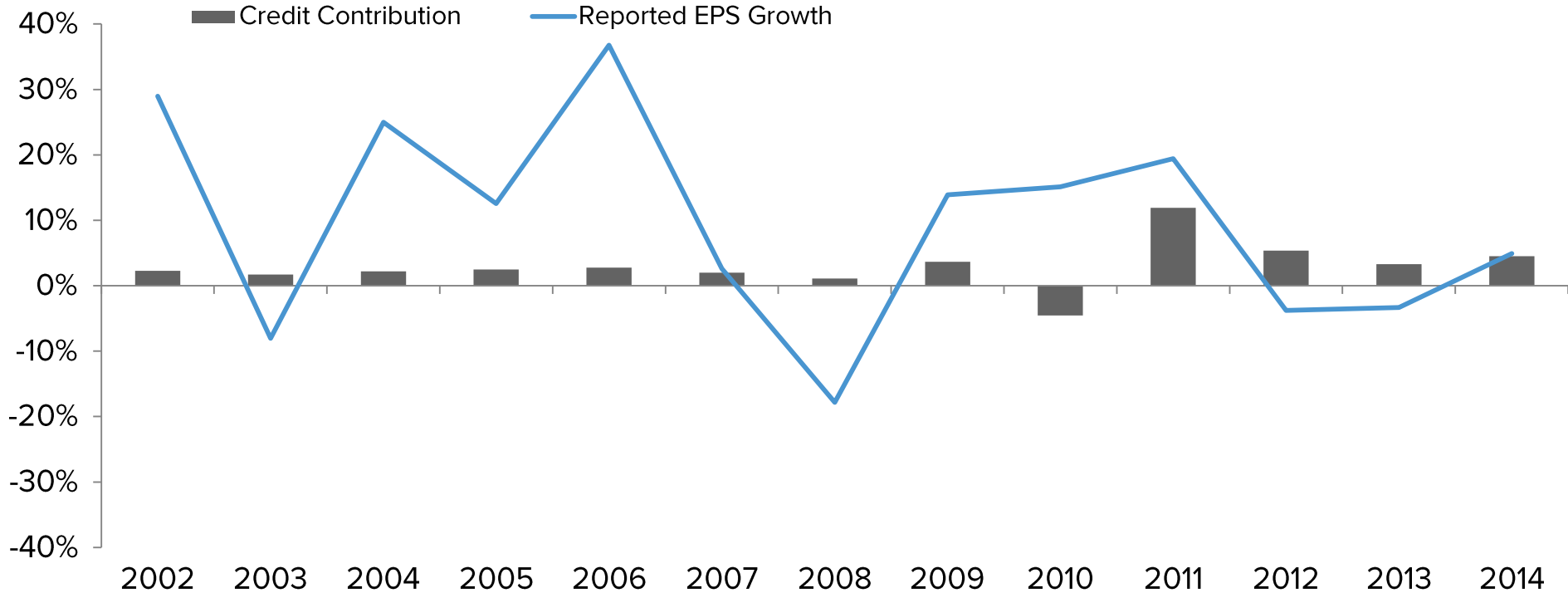
Discounts/Sales Events are the biggest reasons people sign up according to our survey. But in hindsight, we could have asked this better. Our sense is that many people sign up at KSS simply because they'll take whatever credit they can get.



APPENDIX



CREDIT DRIVING EPS GROWTH

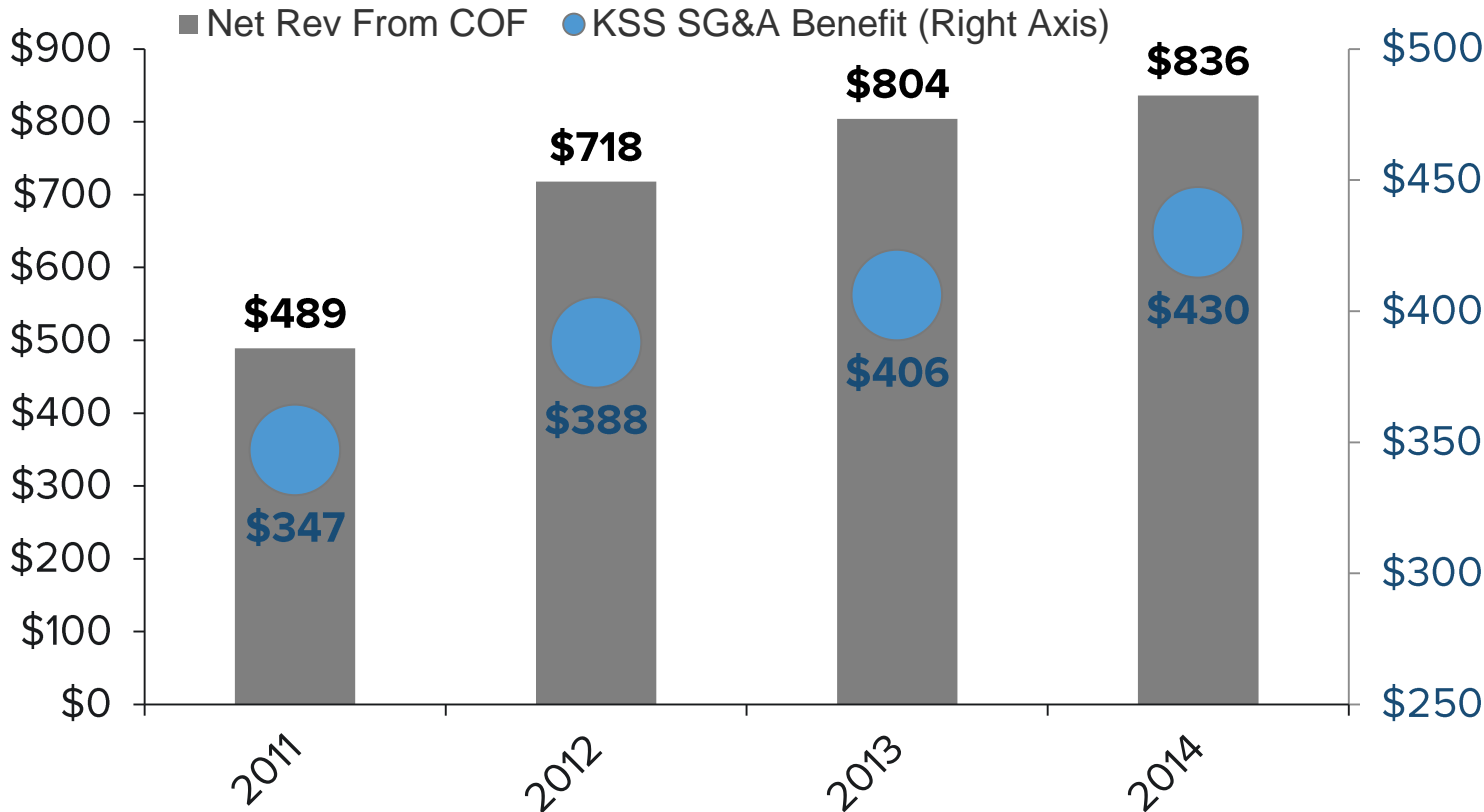


REPORTED EPS GROWTH & CREDIT CONTRIBUTION

Earnings have not grown in four years without the credit benefit.

CREDIT CARD SG&A HEADWIND

NET CREDIT CARD REVENUE (MILLIONS)



KSS increasing credit yield by partnering with COF

In 2014, the \$836 is what COF recognizes as income sent to KSS for the partnership.

The \$430 is what is booked as a contra-cost on KSS SG&A line after marketing/service expenses for the card.

That's 10% of SG&A and 25% of EBIT.

CREDIT AGREEMENT DETAILS

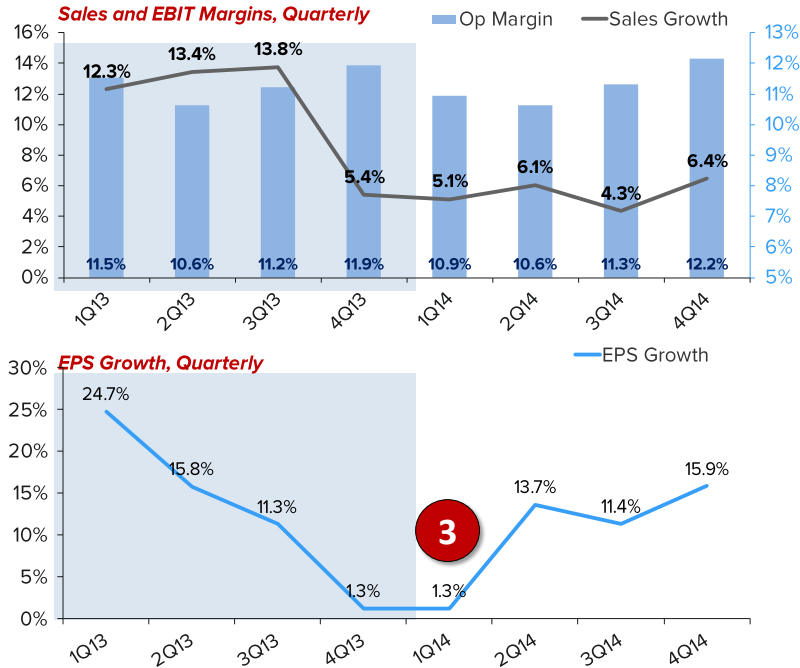
KOHL'S & CAPITAL ONE AGREEMENT

The Kohl's logo is displayed in a bold, maroon, sans-serif font.

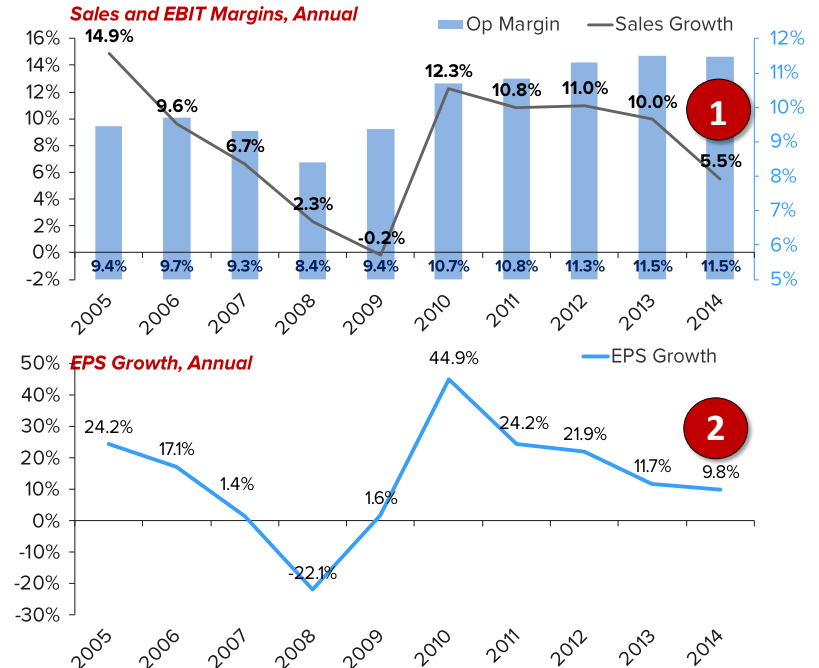
Credit Card Revenue		
Shared ~50% Exempt from paying	Finance Charges, Late Fees, Other Fees Merchant Transaction Fee	Shared ~50% NA
Credit Card Costs		
100% Shared ~50% Shared ~50%	Marketing & Customer Service Cost of Funding Receivables Charge-Off Risk Underwriting Account Debts	~50% Shared ~50% 100%

CHALLENGING QUARTERLY BACKDROP

Retail Softlines Income Statement, 8-Quarter Trend



Retail Softlines Income Statement, 10-Year Trend



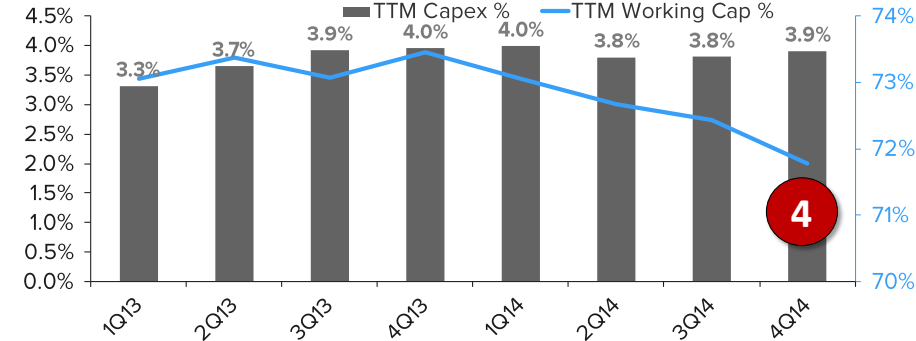
INDUSTRY SALES, MARGINS AND EARNINGS – 10-YEAR (RIGHT) AND 8QTR (LEFT)

1) Sales have been steadily decelerating while margins set new peak. 2) EPS growth has therefore slowed materially. 3) The quarterly EPS compare gets EXTREMELY difficult after 1Q15.

CHALLENGING QUARTERLY BACKDROP

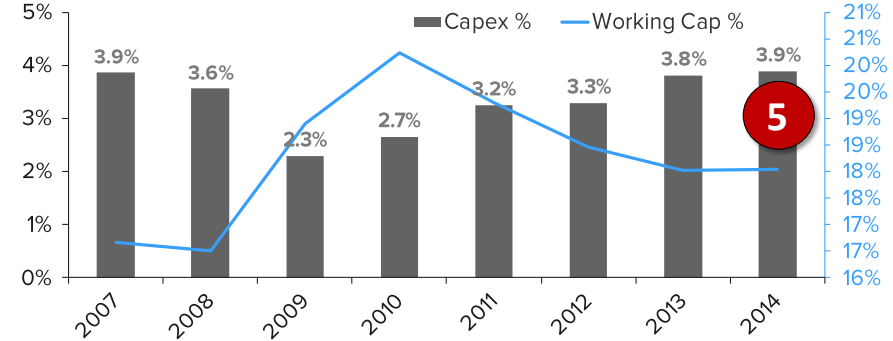
Retail Softlines Capital Intensity, 8-Quarter TTM

Retail Softline Capex vs Working Capital, Annual



Retail Softlines Capital Intensity, 10-Year Trend

Retail Softline Capex vs Working Capital, Annual

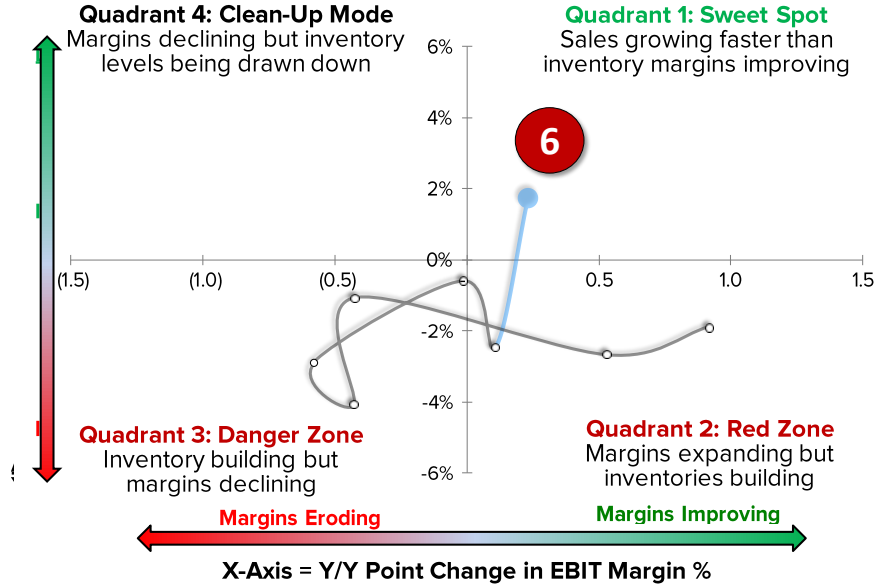


CAPITAL INTENSITY, 10-YEAR AND 8 QUARTER

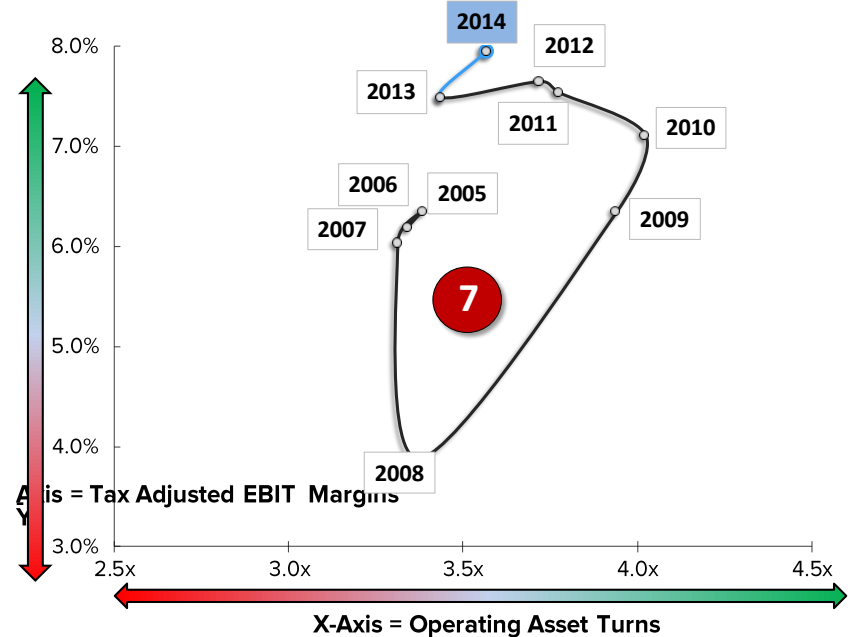
- 4) Working capital is trending to the lowest levels in years.
- 5) Capex has ticked up steadily, and will go well above 4% in 2015 (perhaps as high as 4.3%).

CHALLENGING QUARTERLY BACKDROP

Softline Retail Industry SIGMA



Softline Retail Industry RNOA

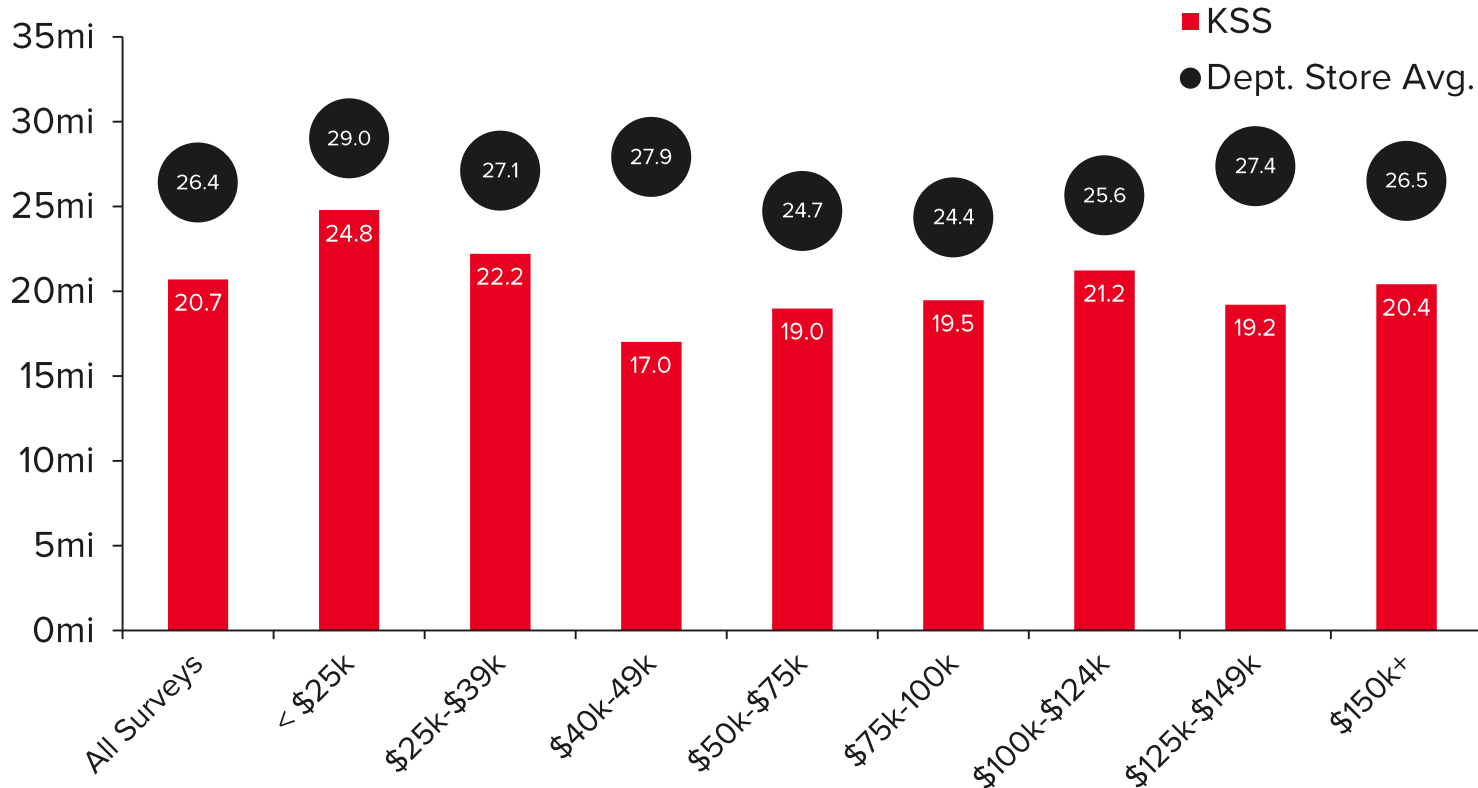


SIGMA AND RNOA ARE ABOUT AS GOOD AS THEY CAN GET

6) Sales better than inventories, and margins positive. We'll likely have one more quarter in this sweet spot (1Q15). From there, any move on the chart is a negative stock event.

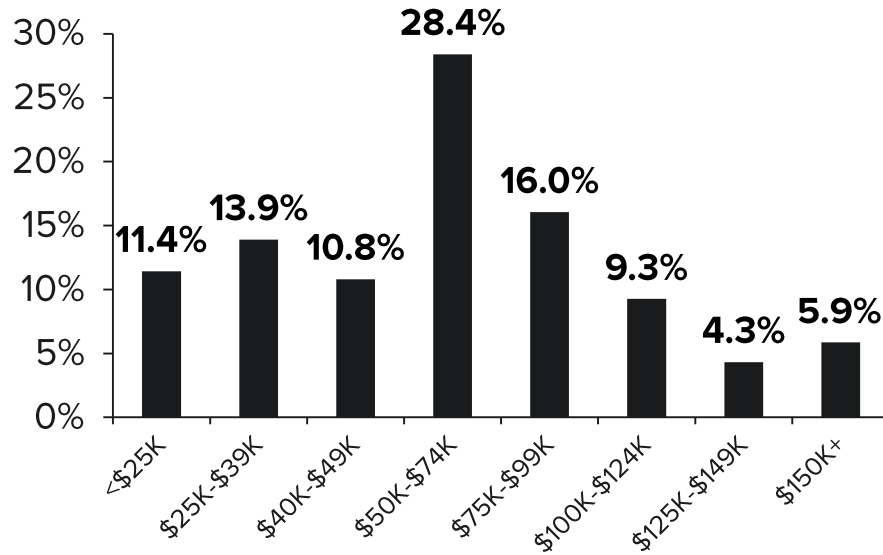
AVG DRIVING DISTANCE

AVG. DISTANCE TO STORE



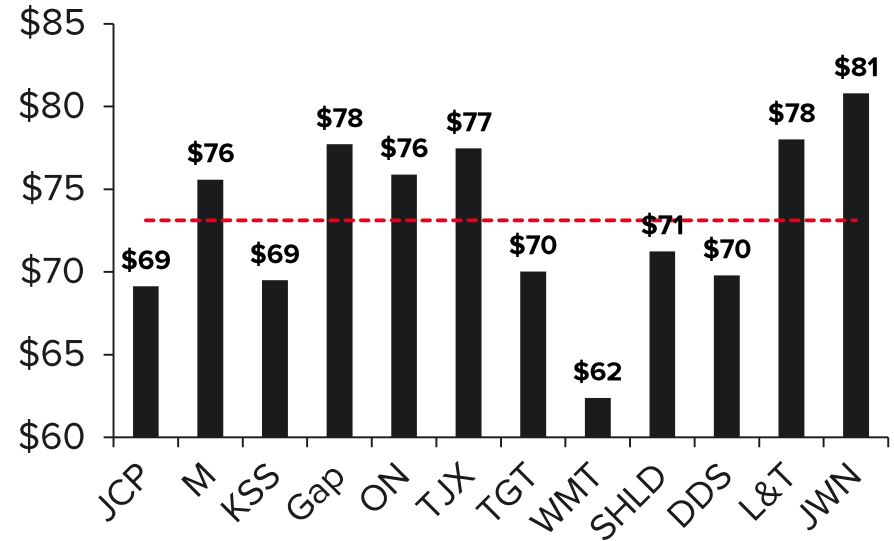
No surprises here. Strip malls are closer to where people live, and that's where all of KSS' stores are located.

INCOME CHARACTERISTICS



KSS CARD INCOME DISTRIBUTION

Two-thirds of KSS card holders have household income below \$75,000.



AVG INCOME PER CARD HOLDER

Survey average (\$73.34)

KOHL'S ACCOUNT EASE

CONTROVERSIAL PAYMENT PROTECTION

-Account ease is a payment protection program providing insurance for cardholders, for a fee, should they encounter circumstances hindering their ability to pay.

-Customers are charged \$1.60 a month per \$100 of the customer's account balance. The company also charges \$14.99 for credit monitoring service.

-The problem is that customers have been consistently enrolled in the Account Ease program without their knowledge.

-Complaints regarding the program fees can be found online dating back to 2009, and culminate with a lawsuit filed in Pennsylvania in February of this year.

-It appears Capital One decided to be proactive in addressing the controversial service and the Credit agreement was amended in May 2014 to include two notable changes:

- “The debt cancellation or debt deferment service referred to as “Kohl’s Account EaseSM” (“KAE”) shall not be offered to new Cardholders or to any existing Cardholders that do not currently subscribe to KAE. In the event that the subscription of any existing Cardholder to KAE expires, Bank shall not offer KAE to any such Cardholder.”
- “Kohl’s shall continue to record all telephone activities related to (i) outbound telemarketing or selling activities in respect of the Private Label Credit Card, the Program or any Enhancement Product, and (ii) requests for cancellation or termination of any Private Label Credit Card or any Enhancement Product (including, without limitation, the previously marketed debt cancellation or debt deferment service referred to as “Kohl’s Account EaseSM”), and any associated retention-related activities, and shall, in each case, provide such recordings to Bank on a weekly basis or as mutually agreed by Kohl’s and Bank.”

FOR MORE INFORMATION, CONTACT US AT:

SALES@HEDGEYE.COM

(203) 562-6500