Off Wall Street

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New Rec: Kohl's (KSS: $42.78) January 16, 2013

Position: Buy **Target: $56.25**

$Mil	Q412e	Q113e	Q213e	2012E	2013E	2014E	2015E
Rev	6,120	4,260	4,239	19,058	19,230	19,480	19,756
EPS$	1.61	0.58	0.95	4.13	4.38	4.90	5.55
Y/Y	-11%	-8%	-5%	-4%	6%	12%	13%
PE	n/a	n/a	n/a	10.3	9.7	8.7	7.7
PSR	n/a	n/a	n/a	0.7	0.7	0.7	0.7
Cons.$	n/a	n/a	n/a	n/a	4.44	4.94	n/a

Shares Out: 230M **Market Cap: $9.7B** **FYE: January**

Concept:

1. KSS shares have sold off sharply due to a weak holiday season. KSS looks underpriced at 9.7X EPS and 4.4X EBITDA, far below historical averages. Current FCF yield is 12%.
2. KSS generates steady FCF. Capex has declined markedly.
3. KSS is aggressively shrinking its share count through share buybacks. Total shares have declined 34% since 2005. We expect a 50% reduction from 2005 by 2015.
4. KSS need only to maintain a relatively flat net income over the next several years in order to meet our EPS estimates and price target.
5. KSS's increasing mix of exclusive brands is driving gross margins. The company also continues to increase the % of Kohl's credit card customers, who visit and spend more.

Summary: Kohl's (KSS) operates 1,146 U.S. department stores that sell moderately priced apparel, footwear, housewares and accessories. KSS shares have declined markedly following the preannouncement of disappointing earnings results for the current quarter (Q412). After suffering from frequent out-of-stock positions in 2011, management made a substantial investment in inventory ahead of the critical 2012 back-to-school and holiday periods. However, holiday sales arrived very late in the season and were below plan. This forced KSS to accelerate markdowns as Christmas approached and resulted in reduced gross margins. As we discuss in the report, we think the bad news is sufficiently reflected in the depressed valuation. Most "street" analysts have reduced their ratings on KSS shares and carry hold or sell ratings. KSS shares seem inexpensive, with a favorable risk-reward profile.

KSS has a long history as a successful value-oriented retail destination with convenient locations and well-known brands. This, combined with a deeply ingrained culture of low-costs and excellent customer service, has enabled KSS to generate consistent profits and cash flow over the past decade, despite several economic recessions. Interestingly, despite the disappointing results in 2012, KSS has managed to increase sales by 42% over the past six years, well above the growth of its direct competitors.

KSS generates strong and relatively predictable free cash flow. After increasing the store base at a high rate of growth for most of the past 20 years, the company has now matured and has reduced the new store growth to the 2%-4% range. Moreover, nearly all of its new stores have a smaller format (~62k SF) compared to its traditional larger format (~82k SF), which enables it to open stores in additional markets and to generate a higher ROI. This (combined with reduced spending on e-commerce facilities and electronic signage) should result in reduced capex, which should enable KSS to maintain ample FCF. Including our 2012 estimate, FCF has averaged $4.25 over the past 4 years. We estimate FCF per share of $4.18, $4.88 and $5.50 in 2012-2014 respectively, above EPS, based on reduced capex and working capital requirements and a continued share count decline.

KSS is run by a shareholder friendly management, which has consistently returned capital to stockholders. In fact, one of the key parts of our thesis is the aggressive share repurchase program. Since 2005, KSS has reduced the overall share count by 34% and has recently increased the existing repurchase authorization to $3.5B. At the current market valuation, this implies that KSS could retire 37% of the current outstanding shares, which would result in a nearly 60% reduction from 2005. Our estimates assume buybacks of $2.9B over the next three years (less than company guidance) executed at gradually higher share prices. Thus, if KSS were to complete the total authorization or were the share price to remain near or below its current level, our estimates could prove conservative.

We know of very few companies that have repurchased shares at such a pace. Similar "share shrinkers" have delivered substantial share price gains over time. Importantly, we think KSS is buying its shares at a price that should be highly accretive to future EPS and FCF. It appears that management views the return on its own shares as more attractive than opening new stores. Moreover, it intends to maintain the company's investment-grade debt rating. Net debt (including capital leases) to EBITDAR is 1.1x. In addition, the company has initiated a cash dividend which provides a current yield of 3%. Importantly, if management maintains the current dollar value of the dividend, as it has stated it would, the per-share dividend should increase at the inverse annual rate of the estimated share reductions (~10%).

A key differentiator for KSS is its growing mix of private and exclusive brands, which carry higher gross margins than its national brands. These brands now account for ~53% of total sales compared to 25% in 2004. KSS continues to develop and introduce new brands based on current trends. Some of the recently launched brands include Jennifer Lopez, Marc Anthony and Rock & Republic, all of which have had very successful early results. Other exclusive brands include ELLE, Lauren Conrad, and Vera Wang. We anticipate the launch of additional exclusive brands. KSS's national brands include Nike, Adidas, Dockers, Levi and Jockey.

KSS has increased its share of private label credit card customers who visit the stores more frequently and purchase far more merchandise than non-credit customers. In 2011, KSS entered into a new 7-year agreement with Capital One, which offers the KSS credit card. KSS and Capital One share in the net risk-adjusted revenue from the card portfolio (finance charges, late fees etc.). In the most recent quarter, credit card customers accounted for 58% of sales vs. 40% in 2006. Moreover, write-offs have been minimal. Our store surveys indicate that the KSS card drives strong customer loyalty.

KSS has invested considerable resources in its online business. As a result, online sales have increased at a compound rate of 40% over the past 4 years to an estimated $1.4B (7.4% of total sales) in 2012 (vs. $357M in 2008). We expect online sales to increase at an average rate of ~18%/annum over the next 3 years. However, while adding to total company profit, online sales have negatively impacted KSS's margin rate due to subsidized shipping costs and a slightly lower margin mix. Substantial expenditures on new fulfillment facilities have also hurt EBIT margins. On the contrary, KSS generates a very high ROI from its online business, and, over time, we expect online sales to achieve a margin closer to (but still below) KSS's company average as higher sales leverage the existing infrastructure. We note that KSS recently completed its fourth e-commerce facility and does not anticipate needing an additional facility for at least three years. Moreover, we note that nearly all of the online merchandise returns result in a store visit and subsequent purchase, which should minimize the impact of cannibalization.

KSS faces a number of headwinds including strong competition, a weak consumer, a recent payroll tax increase, little new store expansion, and recent poor merchandise execution. However, as we discuss in the report, we think most of this is discounted in the current depressed valuation as investors have apparently given up on the stock. KSS looks very inexpensive at 9.7x and 8.7x our respective 2013 and 2014 EPS estimates and even cheaper based on FCF. Importantly, our estimates are based on conservative assumptions. These include flat same-store sales, flat gross margins, and no leverage from SG&A. Offsetting these assumptions are modest store growth, substantial (and accretive) reductions in the share count, and continued penetration by private/exclusive brands and credit card customers.

We note that more than half of KSS stores are either new or have been remodeled within the past 5 years. KSS stores are also smaller than its direct competitors' stores and are located in attractive, convenient non-mall locations (strip centers, standalone neighborhood stores). The company recently completed the installation of electronic price signage in all of its stores. As we discuss in the report, this should drive a substantial reduction in costs, and should increase KSS's pricing efficiency and inventory management. KSS also has significant asset value.

It owns 407 of its stores and all of its distribution facilities. We value these assets at ~$6B vs. the current market cap of $9.6B. At the very least, this should provide an additional margin of safety for KSS investors.

KSS shares could benefit from one or more potential positive catalysts. First, margins could expand based on lower apparel costs (which increased 12% in 2011 due to high cotton prices) and increased leverage of the relatively new online fulfillment centers. KSS also has an opportunity to increase sales in its warmer markets (south and west), where both store productivity and credit card penetration are well below the company average. Any multiple expansion could result in a meaningful increase in the share price.

To put our assumptions into perspective, consider that our 2015 forecast is for net income of $992M, which is just 1.6% higher than the net income KSS reported in 2009, a year which included the tail end of a major recession and in which online sales were just $492M (vs. our 2015e of $2.2B). However, given the considerable share reduction that has occurred combined with our estimates of future reductions, our 2015e EPS is $5.55 or 75% higher than the 2009 EPS of $3.17. Note that in 2009, KSS shares traded in a range of $35-$60. More importantly, we think our estimates could prove to be conservative, with substantial room for upward revision. We note that our EPS forecast is slightly below consensus for 2014.

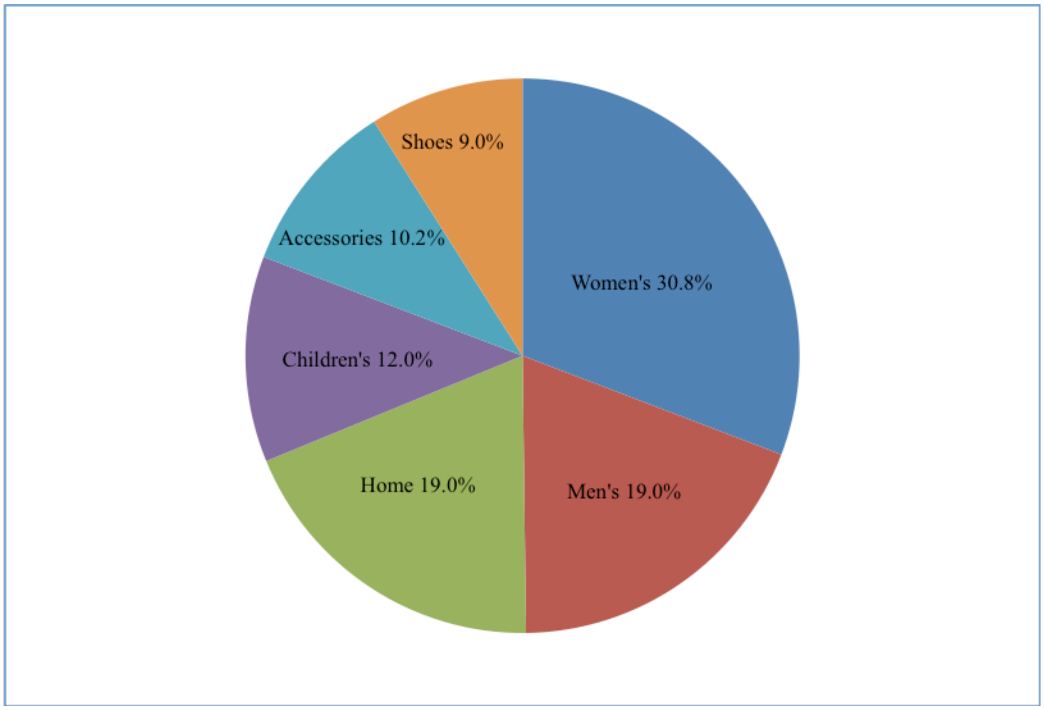
KSS shares seem attractive for patient investors, especially against the backdrop of an equity market trading near the top of its multi-year range. The risk/reward seems compelling. KSS shares are trading at < 10x our forward EPS. We note that KSS shares troughed at 9x EPS during the financial crisis of 2008-2009. As we discuss in the report, we think the shares should be valued at 11x-12x EPS. Based on our 2014 estimated EPS of $4.90, we establish a 12-18 month price target of $56.25. Including the expected dividends, this would imply a total return of 40% over the next 18 months. Importantly, we view the potential downside as modest (12%) due to the low valuation, strong FCF, aggressive (and accretive) share repurchases and the stable history of the business. This results in a 1:3 risk reward ratio.

Background:

Founded in 1962, Kohl's (KSS) 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. Its stores generally carry a consistent merchandise assortment with regional differences.

Approximately 53% of sales are from quality private label and exclusive brands (found only at Kohl's). At October 31, 2012, KSS operated 1,146 stores in 49 states. KSS also offers online shopping at Kohls.com with a primary focus on extended sizes, product line extensions and web-exclusive items. Online sales increased an estimated 38% in 2012 and accounted for roughly 7.4% of total sales. In Table 1, we detail revenue by merchandise mix. KSS is headquartered in Wisconsin. Its fiscal year ends in January.

Table 1: Merchandise Mix



Discussion:

1. KSS is a leading retailer of moderately priced branded merchandise to the lower and middle class U.S. consumers. Over the past decade, KSS has delivered fairly steady net income by offering private label/exclusive brands and leading national brands in attractive and conveniently located stores across the U.S. The KSS share price has been a laggard and has experienced a number of fits and starts based mostly on seasonal performance. Investors who have purchased KSS at times when the stock has been out of favor have been generously rewarded. We think now is one of those times.

KSS shares have declined markedly following a recent poor showing during the all-important holiday season (30% of annual sales). Following soaring apparel costs in early 2011 (rising cotton prices), management reduced inventory units too aggressively, which resulted in costly out-of-stock positions later in the year. In 2012, it responded by packing the stores with inventory. However, while the important back-to-school period was a strong one for KSS (as evidenced by its Q3 EPS beat), Q4 sales (Nov-Jan) came in below expectations. November sales declined 5% y/y, partially due to repercussions from hurricane Sandy (which hit the east coast at the end of October). More importantly, however, December sales, while up 3.5% y/y, arrived much later than expected forcing KSS to increase markdown/clearance activity around Christmas and into January. As a result, gross margins (and EPS) are expected to be meaningfully below plan. Management is currently guiding Q4 EPS of $1.61 compared to estimates that had drifted down toward the $1.80 level before the pre-announcement. Not surprisingly, sell-side analysts have slashed their ratings on KSS shares.

Our investment thesis is relatively straightforward. We think that the company can deliver steady net income over the next 2-3 years (starting from a somewhat depressed base in 2012), which, when combined with aggressive share repurchases, a meaningful dividend and slight multiple expansion, should result in a 40% potential total return over the next 12-18 months, with modest downside risk. Achieving stable net income should not be too difficult for KSS and could be accomplished by the following: flat to -2% same-store sales at the store level; continued high growth of online sales (CAGR 18%+); new store growth (based on square footage) of 2%-3%; continued expense productivity (via electronic signage, smaller new stores and moderating spending for advertising, IT and e-commerce infrastructure). We expect KSS to maintain steady gross margins with a slight increase in annual interest expense.

Assuming net income remains flat, EPS should grow at 10%+ based on the company's continued aggressive share repurchases. In addition, investors are receiving a 3%+ yield while they await better top line results. Moreover, based on our assumptions about the share count reduction, the per-share dividend would increase as well. The result is a 15%-20% annual total shareholder return before accounting for any multiple expansion. As we discuss below, we think some multiple expansion is warranted. There is also the potential for margin upside. Thus, our estimates could prove to be conservative. However, even if our forecast proves too optimistic, the share price downside should be limited due to the depressed current valuation, strong FCF and share repurchase program.

2. One of the most compelling attributes of KSS is the company's ability and willingness to aggressively return capital to shareholders with share repurchases. It appears that the company views buying its own shares as a superior use of capital

vs. opening new stores. Based on the amount of shares that KSS has repurchased (and plans to repurchase in the future), the company fits into a category that we refer to as "share shrinkers," or what Buffett has termed "cannibals." As we highlight in Table 2, the KSS share count has gone from 349M shares at the end of 2005 to an estimated 229M shares at 1/31/13, a decline of 34%. Moreover, the board of directors recently approved an increase in the repurchase authorization to $3.5B. Management has stated that it intends to execute the entire amount over the next three years. Our forecasts assume the buybacks are completed in a linear fashion, although the company remarked that it would accelerate activity if the stock remains inexpensive. Considering that KSS spent $2.3B in 2011 to repurchase shares at an average cost of ~$50, we would characterize the current share price as attractive. Moreover, we estimate KSS will repurchase $2.9B worth of shares over the 2013-2015 timeframe (less than management guidance of $3.5B) at an average price of $49.75 per share. Therefore, if the share price were to remain depressed or decline further, our estimates regarding the timing, cost and degree of the buyback could all prove conservative.

Table 2: Share buyback activity

FY*	2005-	2009	2010	2011	2012e	2013e	2014e	2015e
Ending shrs	346	307	291	247	229	205	186	173
Y/Y % chg		0.3%	-5.2%	-15.1%	-7.5%	-10.1%	-9.3%	-7.3%
Cum. % chg		-11.2%	-15.8%	-28.6%	-33.9%	-40.6%	-46.1%	-50.0%
Net income	841	973	1,120	1,165	979	951	960	996
EPS	$2.43	$3.17	$3.66	$4.30	$4.13	$4.38	$4.90	$5.55

*FY ends January of following year

The KSS share repurchase program has been facilitated by the company's ample and fairly predictable cash flow. Over the past 7 years, operating cash flow has averaged $1.74B and has remained in a tight range. As new store expansion has slowed, capex has declined markedly, enabling FCF to remain ample even as earnings have been below expectations. We forecast capex at $800M and $740M respectively in 2012 and 2013. This compares to peak capex of $1.5B in 2007.

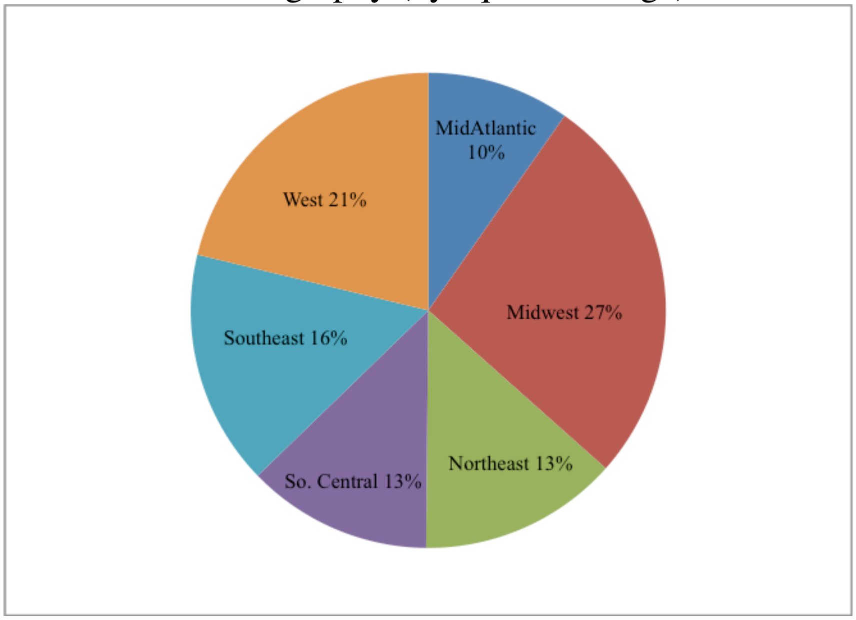
Even with the considerable share buyback, KSS has maintained a strong balance sheet. We estimate the ratio of net debt + capital lease to EBITDAR to be 1.1x for the 2012 fiscal year ended 1/31/13 including a cash balance of ~$860M. This is well below management's stated limit of 2.2x. The company has an investment grade rating, which management is intent on maintaining. KSS also generates a solid return on investment (ROI). Over the past 5 years, its ROE has been in the 14%-18% range, while its EBITDAR return on investment has averaged 19%.

Lastly, KSS has considerable asset value. The company owns 407 stores (~31M SF), 9 distribution centers, 4 e-commerce facilities and a headquarters building in Wisconsin. Based on replacement cost estimates and the value of similar structures in recent transactions, we value KSS's properties at about $6B. While we do not expect management to monetize property through sale leaseback transactions, this strong asset base provides KSS with financial flexibility and shareholders with additional margin of safety.

3. KSS is a family-focused, value-oriented specialty department store offering popular national, exclusive (licensed) and private label apparel, footwear, accessories, and beauty and home products. KSS stores are conveniently located (close to residential areas), with ample parking, wide store aisles and fast centralized checkouts. The traditional prototype KSS store is 88k square feet, although in the past several years, KSS has been opening mostly smaller stores (~62k SF). Management has been pleased with the returns on the smaller-format stores and this will be the primary growth vehicle in the years ahead. Within a KSS store, centrally located registers are designed to expedite checkout and new electronic signage streamlines and optimizes the merchandise pricing mechanism (and should drive significant labor savings). Roughly 68% of the store base is located in strip centers with another 25% located in free standing locations. Only 7% of stores are located in traditional malls (where traffic has declined over recent years). More than 50% of the stores are either new stores or have been remodeled within the past 5 years. As we highlight in Table 3, KSS stores are also well diversified by geography.

KSS continues to increase its mix of exclusive licensed and private label brands (E&P brands), which differentiate it from direct competitors. Importantly, KSS retains significant control over the manufacture of its E&P products, which gives it more pricing flexibility and enables it to generate higher margins. E&P brands have also experienced higher sales growth vs. national brands. For example, in 2011, E&P comparable sales increased ~5% vs. overall comparable sales of 0.5%. In 2012, KSS's E&P brands should account for an estimated 53% of sales compared to 25% in 2004. The most recently launched exclusive licensed brands have outperformed expectations. These include Jennifer Lopez, Mark Anthony, Rock & Republic, LC Lauren Conrad, Dana Buchman, ELLE, Simply Vera (Vera Wang) and Food Network. KSS also offers older exclusive brands (Chaps, Candies and FILA). Its key private label brands are Sonoma, Apt. 9 and Croft & Barrow.

Table 3: Store Geography (by square footage)



We expect KSS to introduce new exclusive brands on a more frequent basis. Design Nation is a new limited-edition collection concept featuring fashions based on international inspiration from premier designers. The first of such collections was launched in November 2012 and features women's apparel designed by Narcisco Rodriguez. The Derek Lam collection is expected to launch in April 2013 and will feature women's apparel and swimwear inspired by Brazilian style.

National brands account for the remaining 47% of KSS sales. With its wide assortments, KSS is the #1 U.S. retailer of Lee, Gold Toe, Levi's, Dockers and Columbia. It also sells Nike, Adidas, Carter's, Van Heusen and Jockey brands.

4. KSS has a culture of strict cost control. Even with increased e-commerce distribution expenses and tepid top line sales growth, SG&A as a % of revenue has declined nearly 100bp over the past 4 years. This has resulted from tight payroll management as well as better performance on credit card operations and lower incentive compensation. In 2013-2014, SG&A should benefit from the recent installation of electronic signage, increased leverage from online sales, a higher mix of small-format stores, and continued progress on the private label credit card.

KSS has also been working to increase its time to market. According to the company, over the past three years, it has reduced the time between development and store delivery from 45 weeks to 25 weeks.

KSS is driving customer loyalty as well as additional revenue with growing penetration of its private label credit card. This is important since the KSS credit customer shops about 12x per year, according to management, which is 3x the frequency of the non-credit customer, and purchases more per visit. In April 2011, KSS commenced a 7-year agreement with Capital One, which offers private label credit cards to new and existing KSS customers. KSS handles all customer service functions, including processing, billing, collections, maintenance of data systems and customer inquiries. It is also responsible for all advertising and marketing to its credit card customers. KSS and Capital One share in the net risk-adjusted revenue of the portfolio, which is the sum of finance charges, late fees and other revenues less write-offs of uncollectible amounts.

We recently surveyed a number of KSS stores in Arizona, Texas, RI and Massachusetts. We found the stores to be generally busy, well stocked, clean and easy to navigate. Customers with whom we spoke had a high regard for the Kohl's brand and the overall store experience and seemed well aware of the Kohl's website.

5. KSS has invested considerable resources in its online business, which has been growing quickly. Online sales have increased at a compound rate of nearly 40% over the past 4 years to an estimated $1.4B (7.4% of total sales) in 2012 (vs. $357M in 2008). We expect online sales to increase at an average rate of ~18% over the next 3 years to $2.24B in 2015. However, online sales have negatively impacted KSS's EBIT margin rate due to subsidized shipping costs and a slightly lower-margin mix. Substantial expenditures on new fulfillment facilities have also impacted the margin. We note that KSS recently completed its fourth e-commerce facility and does not anticipate needing an additional facility for at least three years. Thus, continued sales growth should result in considerable EBIT leverage. Management expects online ROI to exceed store level ROI within a few years. Over time, it also expects online sales to achieve a margin closer to (but still below) KSS's company average, as higher sales leverage the existing infrastructure. Importantly, the company estimates that 95% of online merchandise returns (due to fit etc.) are done at a KSS store and most often result in a related store purchase. This should mitigate the impact of online cannibalization.

6. Like most retailers, KSS faces a number of potential risks. The key risk, in our view, is a generally weak U.S. consumer, which could lead to lower store traffic and increased price competition. The recent increase in payroll taxes could impact spending by middle and lower income consumers. Increased online sales growth

could also cannibalize KSS's store sales and result in reduced return on store investment. Poor merchandising decisions could lead to reduced consumer demand for KSS products. Lastly, unusual weather patterns could impact KSS sales.

7. Recent results

In the most recent reported quarter (Q312), revenue increased 2.6% to $4.5B on same-store sales of 1.1%. Transactions per store declined 0.5% y/y while the average transaction value increased 1.6%, driven by higher-priced exclusive brands. Online revenue increased 50% to $295M and contributed 230bp to comparable sales. Private and exclusive brands accounted for 53% of sales (+150bp y/y) while KSS credit card share increased to 58% vs. 57% in Q311.

Gross margin declined to 38.1% from 38.5% due to sharper pricing and increased online mix. Inventory per store increased 17% in dollars and 14% in units. On a two-year basis, however, inventory units increased 3%. SG&A expense increased 0.6% and was 24.0% of sales. EBIT increased 2.4% to $425M or 9.5% of sales. EPS increased 15% y/y to $0.91 on an 11% decline in average shares. During the quarter, KSS repurchased 5M shares for $260M ($52/share).

8. Financial assumptions

Our estimates are based on the following assumptions: for 2013, which ends in January 2014, revenue should increase 0.9% to $19.2B. This is based on flat same-store sales and a 1% increase in selling square footage. We note that 2012 included an extra week. Online sales should increase 24% y/y vs. a 40% increase in 2012. Brick & mortar (store level) sales should decline 0.8%. We estimate total gross margin at 36.6% vs. 36.7% in 2012 and 38.2% in 2011. This is driven by increased online sales, mix changes and an increase in promotional pricing. Next we estimate depreciation at 4.4% of sales or $850M, which results in EBIT of $1.86M or 9.7% of sales. EBITDAR is $2.98B or 15.5% of sales. Net interest expense should increase about 3% in 2013 to $338M. Using an income tax rate of 37.5%, net income would be $951M vs. $978M in 2012. Lastly, we estimate an 8.5% decline in average shares. This results in 2013 EPS of $4.38, up 6.3% vs. 2012.

2013 Free cash flow is estimated at $1.06B or $4.88 per share vs. $4.18 in 2012. This is based on operating cash flow of $1.8B and capex of $740M. Our estimate includes a net working capital impact of -$120M. Lastly, we estimate that KSS repurchases 25M shares for a cost of $1.1B in 2013. At 1/31/14, we estimate cash and investments at $759M, debt at $2.4B and net capital leases at $1.9B for a total net debt/cap lease of $3.6B or 1.2X 2013 EBITDAR.

For 2014, which ends in January 2015, revenue should increase 1.3% to $19.5B. This is based on flat same-store sales and a 1.3% increase in selling square footage. Online sales should increase 16.5% y/y to $2B. Store level sales should decline 0.3%. We estimate total gross margin at 36.6% (flat y/y). Next, we estimate depreciation at 4.4% of sales or $857M, which results in EBIT of $1.88M or 9.6% of sales. EBITDAR is $3B or 15.5% of sales. Net interest expense should increase 1.7% in 2014 to $344M. Using an income tax rate of 37.5%, net income would be $959M, +0.8% y/y. Finally, we estimate a 9.7% decline in average shares. This results in 2014 EPS of $4.90, up 12% vs. 2013.

Free cash flow is estimated at $1.07B or $5.50 per share vs. $4.88 in 2013. This is based on flat operating cash flow of $1.8B and capex of $745M. Our estimate includes a net working capital change of -$105M. Lastly, we estimate that KSS repurchases 21M shares for a cost of $1B in 2014. At 1/31/15, we estimate cash and investments at $654M, debt at $2.56B and net capital leases at $1.9B for a total net debt/cap lease of $3.8B or 1.3x 2014 EBITDAR.

9. In our view, KSS shares represent a compelling risk-reward investment for the patient investor. Although we recognize that KSS shares could experience high volatility around seasonal earnings reports, we note that the company has a long history as a successful retailer and has delivered relatively consistent earnings and cash flow over many years. Our thesis is simple. As discussed in the report, KSS should deliver stable net income over the next 2-3 years through modest sales increases (1%+) and flat margins. If we layer in aggressive share repurchases (financed primarily with internal FCF), EPS should grow by ~10% annually. Add to that a 3% dividend, which should also grow annually, and a slight increase in the earnings multiple, and the result is a 40% return for investors over the next 12-18 months.

Our estimates could prove to be too low, especially if KSS performs even slightly better than our conservative assumptions for either sales or margins. Moreover, we do not require above consensus earnings in order to achieve our total return projections. To meet our existing estimates requires no great feat on the part of KSS. To reiterate, our 2015 estimate is for net income that is just 1.6% greater than what KSS generated in 2009, a year that included two quarters of a major recession and in which online sales were just $492M (vs. our 2015e of $2.24B). With the completed and anticipated share reductions, however, our 2015e EPS is

$5.55 or 75% greater than the 2009 EPS of $3.17. Surprisingly, the KSS share price remains near the low end of its 2009 trading range ($35-$60). This is evidence that investor sentiment has become abysmal and that expectations for KSS earnings are very low. Importantly, considering the current depressed valuation, we view the downside risk to be limited (~12%), especially given the strong cash flow and balance sheet and the significant accretive repurchase program.

KSS shares could also benefit from one or more potential positive catalysts, none of which are embedded into our forecasts. First, margins could expand based on lower apparel costs (which increased 12% in 2011 and by another 2-4% in the first half of 2012) and increased leverage of the relatively new online fulfillment centers. The newly installed state of the art electronic price signage could also drive meaningful cost savings. KSS also has an opportunity to increase sales in its warmer markets (south and west), where both store productivity and credit card penetration are well below the company average. Recent turmoil at competitor JC Penney could also benefit KSS in the short term as could a re-acceleration of new store growth. For example, management has noted that there is always the possibility that it could capitalize on a mass closing of stores by a competitor (Sears).

KSS shares are trading at < 10x our forward EPS (compared to its 5-year average of 13.1x), 4.3X EV/EBITDAR and a FCF yield of 12.5%. It also trades at a substantial discount to our estimated private market value. We note that KSS shares troughed at ~9x EPS during the financial crisis of 2008-2009. We think the shares should be valued at a minimum of 11x-12x EPS given its strong proven financial history, solid balance sheet and shareholder-oriented management. Based on our 2014 estimated EPS of $4.90, we have established a 12-18 month price target of $56.25 based on a multiple of 11.5x. At our price target, KSS would be valued at 10.2x 2014e FCF and 5.3x EBITDAR. Including the expected dividends, our target price would provide a total return of 40% over the next 18 months, or a 3:1 reward-risk ratio.

10. Financial Projections

a. annual projections	2010	2011	2012e	2013e	2014e	2015e
Sales	18,391	18,804	19,058	19,230	19,480	19,756
Cost of goods (LIFO)	11,359	11,625	12,060	12,183	12,342	12,497
Gross profit	7,032	7,179	6,998	7,047	7,138	7,259
SG&A	4,190	4,244	4,281	4,337	4,402	4,455
Depreciation	750	778	833	850	857	863
EBIT	2,092	2,157	1,884	1,859	1,879	1,941
Net interest expense	304	299	328	337	344	347
Pretax profit	1,788	1,858	1,556	1,522	1,535	1,594
Income taxes	668	693	577	571	576	598
Net income	1,120	1,165	979	951	960	996
EPS	$3.66	$4.30	$4.13	$4.38	$4.90	$5.55
Average shares	306	271	237	217	196	180
EBITDAR	3,106	3,200	2,989	2,986	3,016	3,087
FCF	3.12	4.49	4.18	4.88	5.50	6.18
% of Sales						
Gross profit	38.2%	38.2%	36.7%	36.6%	36.6%	36.7%
SG&A	22.8%	22.6%	22.5%	22.6%	22.6%	22.5%
Depreciation	4.1%	4.1%	4.4%	4.4%	4.4%	4.4%
EBIT (LIFO)	11.4%	11.5%	9.9%	9.7%	9.6%	9.8%
Net interest expense	1.7%	1.6%	1.7%	1.8%	1.8%	1.8%
Pretax profit	9.7%	9.9%	8.2%	7.9%	7.9%	8.1%
Income taxes	37.4%	37.3%	37.1%	37.5%	37.5%	37.5%
Net income	6.1%	6.2%	5.1%	4.9%	4.9%	5.0%
EBITDAR	16.9%	17.0%	15.7%	15.5%	15.5%	15.6%
Y/Y % Chg						
Store level sales	5.9%	0.8%	-0.8%	-0.9%	-0.2%	0.2%
E-commerce sales	47.4%	37.9%	38.8%	24.0%	16.5%	12.0%
Total Sales	7.1%	2.2%	1.4%	0.9%	1.3%	1.4%
Same-store sales	4.4%	0.5%	2.0%	0.0%	0.0%	0.0%
Gross profit	8.2%	2.1%	-2.5%	0.7%	1.3%	1.7%
SG&A	6.0%	1.3%	0.9%	1.3%	1.5%	1.2%
Depreciation	9.0%	3.7%	7.1%	2.0%	0.8%	0.7%
EBIT	12.5%	3.1%	-12.7%	-1.3%	1.0%	3.3%
Net interest expense	1.0%	-1.6%	9.7%	2.8%	1.9%	1.0%
Pretax profit	14.8%	3.9%	-16.3%	-2.2%	0.9%	3.8%
EPS	15.3%	17.5%	-4.0%	6.3%	11.7%	13.2%
Average shares	-0.2%	-11.4%	-12.5%	-8.5%	-9.7%	-8.3%

(amounts in $000, except ratios)	
Current debt	2,235,000
Current Equity	6,106,000
Current tangible BV	6,106,000
Current market value	9,732,500
Current cash	863,840
Current DSO	5
Current DIO	61

FYE January	2012	2013e	2014e
EBIT	2,157,000	1,883,598	1,859,444
EBITDA	2,935,000	2,716,598	2,709,444
Free cash flow	1,216,000	991,840	1,057,940
Surplus cash flow (NI+D&A - capex)	1,016,000	1,011,840	1,061,340
Capex	927,000	800,000	740,000
EV/EBITDA	3.8	4.1	4.1
EV/(EBITDA-capex)	5.5	5.8	5.6

b. quarterly projections	Q112	Q212	Q312	Q412e	Q113e	Q213e	Q313e	Q413e
Sales	4,243.0	4,205.0	4,490.0	6,120.3	4,260.0	4,238.6	4,525.9	6,193.7
Cost of goods	2,719.0	2,563.0	2,778.0	4,000.2	2,745.8	2,619.5	2,815.1	3,982.6
Gross profit	1,524.0	1,642.0	1,712.0	2,120.1	1,514.2	1,619.2	1,710.8	2,211.2
SG&A	1,002.0	975.0	1,077.0	1,227.5	1,012.0	984.8	1,089.9	1,243.4
Depreciation	201.0	210.0	210.0	212.0	208.3	211.8	212.4	214.0
EBIT	321.0	457.0	425.0	680.6	293.8	422.6	408.5	753.7
Net interest expense	82.0	80.0	80.0	86.0	84.0	84.5	85.0	85.0
Pretax profit	239.0	377.0	345.0	594.6	209.8	338.1	323.5	668.7
Income taxes	85.0	137.0	130.0	224.8	78.9	127.1	121.6	251.4
Net income	154.0	240.0	215.0	369.8	130.9	211.0	201.8	417.3
EPS	$0.63	$1.00	$0.91	$1.61	$0.58	$0.95	$0.93	$1.95
Average shares	245.0	239.0	235.0	230.0	226.0	221.0	217.0	214.0
% of Sales								
Gross profit	35.9%	39.0%	38.1%	34.6%	35.5%	38.2%	37.8%	35.7%
SG&A	23.6%	23.2%	24.0%	20.1%	23.8%	23.2%	24.1%	20.1%
Depreciation	4.7%	5.0%	4.7%	3.5%	4.9%	5.0%	4.7%	3.5%
EBIT	7.6%	10.9%	9.5%	11.1%	6.9%	10.0%	9.0%	12.2%
Net interest expense	1.9%	1.9%	1.8%	1.4%	2.0%	2.0%	1.9%	1.4%
Pretax profit	5.6%	9.0%	7.7%	9.7%	4.9%	8.0%	7.1%	10.8%
Income taxes	35.6%	36.3%	37.7%	37.8%	37.6%	37.6%	37.6%	37.6%
Net income	3.6%	5.7%	4.8%	6.0%	3.1%	5.0%	4.5%	6.7%