

DEFAULT CASE STUDY

JUNE 18, 2020

J.C. Penney, Inc.

ABOUT

J.C. Penney, Inc., a Texas-based departmental chain with about 850 stores, defaulted on an interest payment in April 2020 and later filed for bankruptcy in May, following mass store closures resulting from COVID-19 restrictions.

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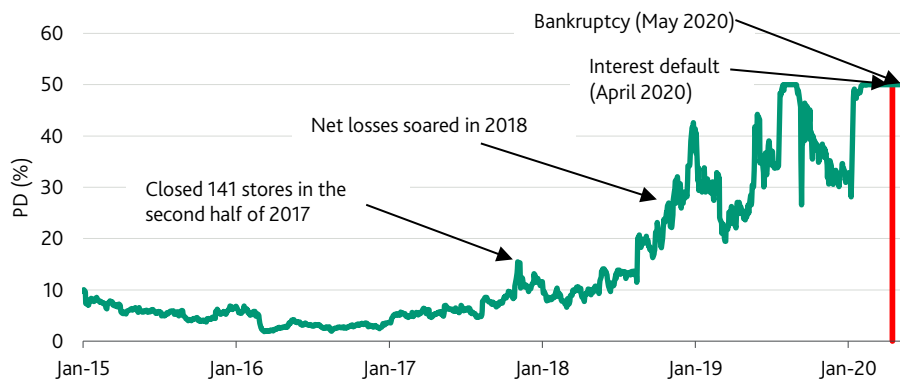
COVID-19 Shutdown Pushes J.C. Penney Into Bankruptcy

On May 15, 2020, J.C. Penney, Inc., a Texas-based department store chain with about 850 stores across the United States and Puerto Rico, filed for bankruptcy. The bankruptcy followed mass store closures resulting from COVID-19 restrictions. It came a month after the company defaulted on the interest payment of its 2036 senior notes. In this report, we use Moody's Analytics public-firm probability of default (PD) metrics to analyze whether this default was foreseeable. Also, we look at possible implications for the retail sector more broadly.¹

What can a credit risk model tell us about J.C. Penney?

Even before COVID-19, J.C. Penney was struggling with a large debt burden and declining revenues due to heightened competition from online retailers. Figure 1 highlights some recent milestones alongside our one-year PD measure.

Figure 1 J.C. Penney's one-year PD (%)



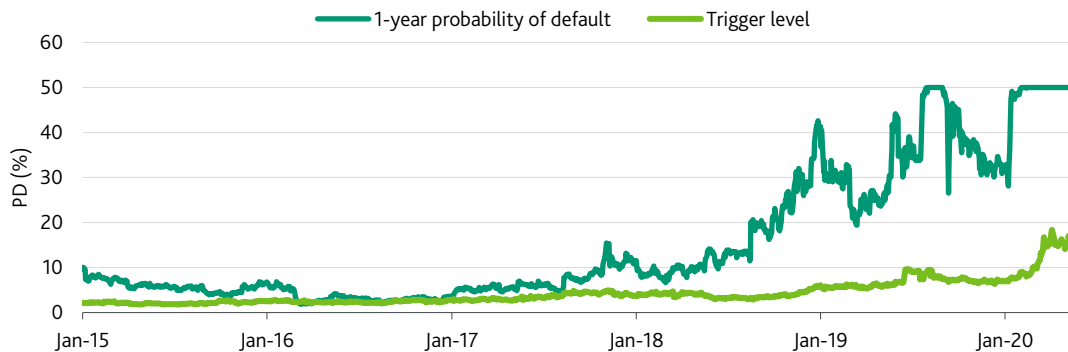
Our public-firm PD metric uses a company's stock price as a data input and reacts immediately to recent market movements. J.C. Penney's one-year PD was 50% right before default, the maximum measure of the EDF model, indicating that the company was highly likely to default.

¹ Data in this report is drawn from the Moody's Analytics public-firm EDF™ (Expected Default Frequency) model.

When did J.C. Penney first show signs of credit deterioration?

To give an actionable metric for each firm, we produce an early-warning monitoring “trigger” calibrated by country and industry. This trigger indicates a credit risk level above which a company may be considered an elevated default risk. J.C. Penney exceeded its trigger in 2017 and moved well above it in the 12 months before default (Figure 2).

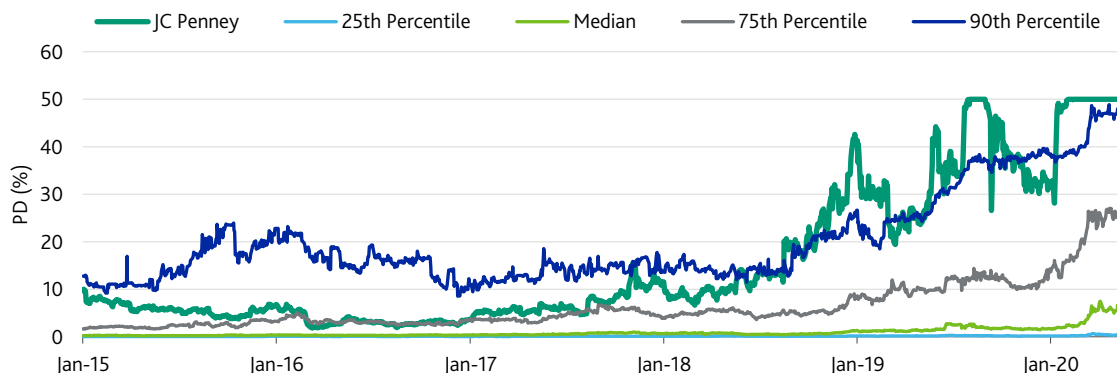
Figure 2 J.C. Penney's PD vs. trigger level (%)



J.C. Penney's performance relative to its peers

We can further understand a company's credit profile by comparing it with its industry peers. A company performing worse than its peer group may have more firm-specific problems driving its credit risk higher. Figure 3 shows J.C. Penney's PD relative to 114 publicly traded consumer retailers and wholesalers in the United States. J.C. Penney moved briefly above the 90th percentile of the group in the second quarter of 2019. The company remained above it for much of the time since then, indicating that it was riskier than almost all its peers, even as its peer group was becoming riskier due to rising online competition.

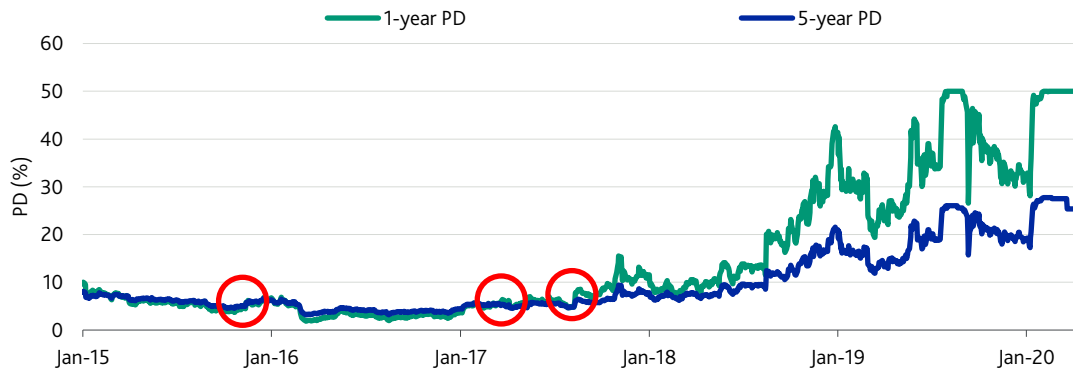
Figure 3 J.C. Penney's PD vs. US consumer products retailer/wholesalers group (%)



J.C. Penney's PD term structure

This section shows J.C. Penney's one-year PD relative to its five-year PD. Similar to a bond yield curve, we expect firms with sound credit to have short-term risk that is lower than long-term risk—an inverted PD curve points to heightened near-term default risk. J.C. Penney's term structure inverted several times during the period 2015–2017, giving a warning sign of default risk, before becoming permanently inverted in August 2017 (Figure 4).

Figure 4 PD term structure (%)



Together, J.C. Penney's PD and associated metrics confirm that it showed elevated default risk since August 2017, with these indicators of default risk becoming heightened in the months leading up to default.

Where do other consumer-related industries stand?

J.C. Penney's default and subsequent bankruptcy occurred soon after restrictions related to the coronavirus pandemic began to take effect. In this instance, the mass closure of stores exposed J.C. Penney's existing credit burden.

To assess whether there are implications for other consumer-facing companies, we use aggregate industry-level data (similar to Figure 3) to examine risk at the 75th percentile of the PD distribution. Most defaulters are above the 75th percentile of their peer group at the time of default. Figure 5 shows five consumer-facing industries, ranked by their 75th percentile PD on June 4, 2020, along with the change since COVID-19 began to affect financial markets globally, from January 20, 2020.

Figure 5 US industries ranked by 75th percentile PD

	INDUSTRY	JUNE 4	JANUARY 20	PERCENTAGE CHANGE	ABSOLUTE CHANGE
1	Entertainment & Leisure	23.8%	17.0%	40%	7%
2	Consumer Products Retail/Wholesale	18.0%	13.6%	32%	4%
3	Apparel & Shoes	9.8%	8.8%	12%	1%
4	Hotels & Restaurants	4.9%	2.3%	115%	3%
5	Food & Beverage	2.6%	3.5%	-27%	-1%

Industries that were heavily affected by the coronavirus lockdown have seen a large increase in credit risk (as indicated by the percentage change column) and appear particularly vulnerable. In Figure 5, Food & Beverage is one of the few industries that has seen its average PD go down during the crisis due to the "essential" nature of the firms in this industry. Risk levels for the Hotels & Restaurants sector more than doubled as their occupancy rates were close to zero because of the lockdown. Consumer product retailers and wholesalers were already facing elevated credit risk due to high rentals, high debt levels, and erosion of market share to online resellers. Another downside surprise, such as a delay in reopening shops, would push more of these firms into default.

Conclusion

J.C. Penney's recent default and subsequent bankruptcy were precipitated by store closures and the revenue shock caused by the coronavirus outbreak, which exposed the company's existing financial weaknesses. Brick and mortar retailers were already struggling under pressure from online retailers and remain highly sensitive to COVID-19 developments.

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