Company Overview

Kohl's Corporation is headquartered in Menomonee Falls, Wisconsin, and operates department stores under the Kohl's name throughout the continental United States and Alaska. Through the company's 1,158 stores, Kohl's offers private, exclusive and national brand apparel, shoes and accessories for women, children and men, as well as small appliances and housewares.

Parent Credit Ratings

Moody's ......................................... Baa2/Stable
S&P ........................................... BBB-/Negative
Fitch ............................................ BBB/Negative

Financial Data

Debt/EBITDA............................................ 2.7x
EBITDA/Interest Expense ....................... 6.0x

U.S. Recommended Corporate Bond Sector Weightings

- Financial (30%-45%)
- Utilities (10%-25%)
- Industrial (35%-55%)

U.S. Recommended Bond Ladder

<table>
<thead>
<tr>
<th>Short-term (up to 5 years)</th>
<th>Intermediate (6-15 years)</th>
<th>Long-term (16+)</th>
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<td>30%-40%</td>
<td>40%-50%</td>
<td>15%-25%</td>
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Sell

Recommendation

We recommend investors sell these bonds. We believe bonds of Kohl's are not an appropriate fixed-income holding because, in our opinion, they offer an unattractive risk/reward scenario at current prices.

Edward Jones Credit Strength Assessment

Investment Summary

We believe there are multiple scenarios that may play out in coming years, most of which would be negative for Kohl's bondholders. These scenarios include 1) possible pressure by investors to take on additional debt to fund share repurchases and dividends in an effort to atone for the stock's significant underperformance over the past three-, five- and 10-year timeframes; 2) the possibility of a leveraged buyout (LBO); and 3) margins that erode as Kohl's target customer continues to feel little economic relief and as the retailing industry becomes increasingly competitive. The probability that measures of importance to bond investors improve in coming years are increasingly small, in our view. We see a higher probability of these measures deteriorating, and we believe clients should sell Kohl's bonds.

Bond Strengths

- Kohl's has actively pursued sales growth by reinvesting cash flow into remodeling and upgrading stores. This may help the company to grow sales organically.
- Kohl's generates significant free cash flow (cash from operations less the amount spent on capital expenditures), and has credit agreements that allow the company to borrow up to one billion dollars, if needed. This liquidity provides financial flexibility and helps the company to support and service its existing debt.

Bond Weaknesses

- Kohl's operates in a highly competitive and cyclical industry that is closely tied to consumer spending and unemployment. As a result, Kohl's sales could respond negatively if the economy were to enter another recession.
- Kohl's stock has significantly underperformed both the S&P 500 and consumer discretionary stocks over the past three-, five- and 10-year periods. We are concerned that this may lead to activist investors or private equity firms showing interest in the company, either of which would likely be negative for bondholders.
- Kohl's employs a shareholder-friendly financial strategy which can be detrimental to bondholder interests. Over the past five years, the company has returned essentially all of the excess cash generated to shareholders via dividends and share repurchases.
- Leverage (a measure of financial risk) has risen in recent years.
Recent News and Analysis

8/10/17: Kohl's reported second-quarter operating earnings per share (EPS) of $1.24, which was above the $1.19 analyst consensus estimate and up from $1.22 in the second quarter of 2016. This quarter showed some improvement in Kohl's sales trends. Comparable sales were down 0.4% from the second quarter of 2016, but this was better than the 2.7% decline in the first quarter. However, despite the slight improvement in second-quarter EPS, net income actually declined by 6% from the second quarter of 2016. The improvement in EPS was a result of Kohl's aggressive share-repurchase program. The gross margin declined in the second quarter primarily due to the growth of online sales, which tend to have lower margins due to the cost of delivery to the customer's home. We believe there are multiple scenarios that may play out in coming years, most of which would be negative for Kohl's bondholders. These scenarios include 1) possible pressure by investors to take on additional debt to fund share repurchases and dividends in an effort to avenge for the stock's significant underperformance over the past three-, five- and 10-year time frames; 2) the possibility of a leveraged buyout (LBO); and 3) margins that erode as Kohl's target customer continues to feel little economic relief and as the retailing industry becomes increasingly competitive. The probability that measures of importance to bond investors improve in coming years are increasingly small, in our view. We see a higher probability of these measures deteriorating, and we believe clients should sell Kohl's bonds.

1/12/17: S&P downgraded the bond rating of Kohl's to BBB-from BBB and maintained its negative outlook on the company. S&P cites the company's weakened operating performance and competitive standing, along with lower customer traffic to the stores and increased competition, as reasons for the downgrade. We share S&P's concerns and believe it is likely that Kohl's investment-grade rating is at risk given the trends we continue to see for this retailer. An additional concern that we would include is the possibility of shareholder activism that may further pressure the company's financial strength given the underperformance of its share price. We continue to recommend clients sell Kohl's bonds. We believe bonds of Kohl's are not an appropriate fixed-income holding because, in our opinion, they offer an unattractive risk/reward scenario at current prices.

Company Outlook

Kohl's seeks to increase market share by creating a better and more convenient shopping experience for its primary customer, moms. While it appears the number of stores Kohl's has opened is reaching the top of its potential, the company has shifted its focus to increase organic sales growth. Of the many strategies the company is pursuing to achieve this goal, one is the Kohl's loyalty program. This program works much like Kohl's credit card reward program and offers customers an incentive to shop at the store. The loyalty program has the added benefit of accessing customers who are either unable or unwilling to obtain a credit card. By offering these purchase incentives, Kohl's may experience sales growth, but overall we have concerns from a bondholder's perspective.

Shareholder Focus

Like many companies in the retail sector, Kohl's employs a somewhat aggressive shareholder rewards strategy. Over the course of the past three years Kohl's has purchased over $2 billion of company stock and paid out an additional $1 billion in dividends. While this practice may be applauded by a company shareholder, from a bondholder's perspective, we would prefer to see this cash reinvested in new projects or used to bolster Kohl's financial strength. The company does appear to be undertaking this strategy without significant disruption to its financial measures (due mainly to the large amount of excess cash the company generates). However, leverage (a measure of financial risk) has risen somewhat over the past three years and we are concerned that this trend may continue.

Weak Stock Performance May Entice Activist Investors

Kohl's stock has significantly underperformed both the S&P 500 and consumer discretionary stocks over the past three-, five- and 10-year periods. We are concerned that this may lead to activist investors showing interest in the company, which would likely be negative for bondholders. The retail sector has been a preferred venue for activists. An activist would be interested in improving the value of Kohl's shares, and this could take many forms. If it was simply an offer of ideas on how to improve operations, this could potentially be a welcome development for both bond and equity holders. However, quite often activists look to add debt to the balance sheet in order to buy back stock or make dividend payments to shareholders. Activists sometimes also request that the company be put up for sale. We believe either of these latter two possibilities would be detrimental to bondholder interests.

Possibility of Leveraged Buyout

Another concern we have with Kohl's bonds is the possibility that private equity firms may show interest in taking the company private in a leveraged buyout (LBO). If this were to happen, Kohl's credit quality would be reduced substantially, since in these transactions the acquirer funds the purchase by issuing significant amounts of debt. LBO candidates tend to have various characteristics in common including being mature companies, having a relatively strong balance sheet (low debt prior to the LBO), steady cash flow, and low future capital expenditure requirements. We feel Kohl's has many of these qualities. The retail sector also has historically been a popular segment of the market for private equity firms to search for LBO candidates.

Concerns Regarding Operations

Kohl's operating earnings have declined every year since 2011 as declining margins have hampered the company. We believe there is further risk to margins as Kohl's continues to battle in an increasingly competitive retail environment. We also believe Kohl's is experiencing a much smaller benefit from an improving economy than higher-end retailers are.
More efficient sales model

By reducing the square footage of an average store, Kohl’s is eager to provide the same shopping experience at a lower cost to the company. This effort coincides with Kohl's ongoing pursuit to remodel existing stores with the expectation that the updated and more customer-friendly environment will generate sales growth in the future. Over the last several years, Kohl's has slowed the pace of new store openings while increasing the rate at which it remodels stores. While some of these upgrades come as a necessary evolution for the company, they could act as a cost-effective way for Kohl's to deliver a better shopping experience to the customer, with the ultimate goal of helping the company become more profitable in the future.

Technology Investment

In recent years Kohl's has been aggressively investing in both internal and customer-facing technology. The internal components of this investment should help Kohl's to better manage its inventory and reduce supply-chain costs. Through investment in its e-commerce platform Kohl's has enhanced its ability to gather and reconcile information about customer tastes and online behavior, which could assist in forming future company strategies.

Product Mix

One of Kohl's operating focal points has been to develop a well-rounded merchandise mix, which helps the company to compete and differentiate itself from its peers. To do this, Kohl's has sought to increase its offerings of private and exclusive brands, which are often not available at competitor stores, therefore providing customers with an incentive to shop at Kohl's. To round out these products, Kohl's also sells national brand merchandise that is common to most department stores.

Industry Outlook

The department store industry is a highly competitive environment that tends to experience fluctuations with the general economy. Therefore, it should not be surprising for the earnings and credit measures of companies within this sector to experience variability as a result of changes in customer tastes, spending and unemployment.

Recent advances in technology have increased the competitive nature of this landscape. As more online retailers enter the market, they seek to gain a share of the sales department stores are also trying to capture. Many large retailers have responded by developing an online presence in order to regain some of these customers. For department stores, sales from online segments often come at a lower margin than sales that are in an actual store. When viewed in isolation, lower margins are not positive for the company; however, the effects of the lower margins are somewhat mitigated by the above-average growth these segments are experiencing.

Financial Strength

Kohl's corporation maintains reasonable credit measures when compared with its large department-store peer group. The amount of debt Kohl's has, relative to its earnings, is comparable to many of the department store's peers. A coverage ratio of 6 times is generally a positive sign and indicates the company can sufficiently service its debt. However, we do have concerns that credit measures may weaken in coming years, especially if the company were to take on additional debt. Separately, Kohl's does tend to produce significant amounts of excess cash, also known as free cash flow. This free cash flow greatly enhances a company's financial flexibility. However, over the past three years, the company has returned essentially all of its free cash flow to shareholders. Bondholders would prefer that this cash be used to pay down debt and improve the balance sheet. We believe there is an increasing risk that the company will become even more shareholder friendly given the underperformance of the stock. Please see Figure 1, which depicts the company’s historical free cash flow (before dividends) and our estimates of future free cash flow.

Figure 1

![Kohl's Free Cash Flow](source: Company Data, Edward Jones)

Edward Jones Credit Strength Assessment

We believe Kohl's credit strength assessment is low. The probability that measures of importance to bond investors improve in coming years are increasingly small, in our view. We see a higher probability of these measures deteriorating because we expect margins to erode and because Kohl's strategy of returning cash to shareholders does little to help credit quality. We believe there is a chance that investors may also pressure for even greater amounts of cash returned to shareholders given the stock's underperformance over the past decade.
The table lists the percent of corporate credits we follow globally in each of the equivalent rating categories. We do not assign a “Buy” rating to any corporate credits. Investment banking services indicate the percentage of those subject companies that have been investment banking clients within the last 12 months.

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<tr>
<th>Appropriate for Income</th>
<th>Appropriate for Aggressive Income</th>
<th>Sell</th>
<th>FYI</th>
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<tr>
<td>Buy</td>
<td>Buy</td>
<td>Sell</td>
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<td>FYI - For informational purposes only. Factual, no opinion.</td>
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Initiated Coverage (Appropriate for Income) 05/02/14... (Appropriate for Income) 05/02/14-08/06/14

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