KOHLS Corp
Form 10-Q
December 04, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended October 31, 2015

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition period from ________ to _________

Commission file number 1-11084

KOHL'S CORPORATION
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Wisconsin | 39-1630919 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| N56 W17000 Ridgewood Drive, Menomonee Falls, Wisconsin | 53051 |
| (Address of principal executive offices) | (Zip Code) |

Registrant's telephone number, including area code (262) 703-7000

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

| | | | |
|---|---|---|---|
| Large accelerated filer | ý | Accelerated filer | ¨ |
| Non-accelerated filer | ¨¬ (Do not check if a smaller reporting company) | Smaller reporting company | ¨ |

Indicate by a check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No ý
Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: November 28, 2015 Common Stock, Par Value $0.01 per Share, 189,820,241 shares outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

KOHL'S CORPORATION
CONSOLIDATED BALANCE SHEETS
(In Millions)

| | October 31, 2015 (Unaudited) | January 31, 2015 (Audited) | November 1, 2014 (Unaudited) |
|---|---|---|---|
| Assets | | | |
| Current assets: | | | |
| Cash and cash equivalents | $501 | $1,407 | $ 631 |
| Merchandise inventories | 5,254 | 3,814 | 4,973 |
| Income taxes receivable | 36 | 25 | 76 |
| Deferred income taxes | 136 | 116 | 125 |
| Other | 276 | 334 | 295 |
| Total current assets | 6,203 | 5,696 | 6,100 |
| Property and equipment, net | 8,499 | 8,515 | 8,671 |
| Other assets | 196 | 207 | 243 |
| Total assets | $14,898 | $14,418 | $ 15,014 |
| | | | |
| Liabilities and Shareholders' Equity | | | |
| Current liabilities: | | | |
| Accounts payable | $2,141 | $1,511 | $ 2,384 |
| Accrued liabilities | 1,244 | 1,160 | 1,162 |
| Income taxes payable | 28 | 78 | 24 |
| Short-term debt | 400 | — | — |
| Current portion of capital lease and financing obligations | 126 | 110 | 109 |
| Total current liabilities | 3,939 | 2,859 | 3,679 |
| Long-term debt | 2,792 | 2,780 | 2,779 |
| Capital lease and financing obligations | 1,817 | 1,858 | 1,886 |
| Deferred income taxes | 305 | 368 | 293 |
| Other long-term liabilities | 571 | 562 | 572 |
| Shareholders' equity: | | | |
| Common stock | 4 | 4 | 4 |
| Paid-in capital | 2,926 | 2,743 | 2,719 |
| Treasury stock, at cost | (9,556) | (8,744) | (8,615) |
| Accumulated other comprehensive loss | (18) | (20) | (21) |
| Retained earnings | 12,118 | 12,008 | 11,718 |
| Total shareholders' equity | 5,474 | 5,991 | 5,805 |
| Total liabilities and shareholders' equity | $14,898 | $14,418 | $ 15,014 |

See accompanying Notes to Consolidated Financial Statements

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KOHL'S CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(In Millions, Except per Share Data)

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | October 31, 2015 | November 1, 2014 | October 31, 2015 | November 1, 2014 |
| Net sales | $4,427 | $4,374 | $12,817 | $12,686 |
| Cost of merchandise sold | 2,784 | 2,746 | 7,990 | 7,908 |
| Gross margin | 1,643 | 1,628 | 4,827 | 4,778 |
| Operating expenses: | | | | |
| Selling, general and administrative | 1,099 | 1,097 | 3,120 | 3,078 |
| Depreciation and amortization | 236 | 227 | 695 | 665 |
| Operating income | 308 | 304 | 1,012 | 1,035 |
| Interest expense, net | 81 | 85 | 248 | 255 |
| Loss on extinguishment of debt | 38 | — | 169 | — |
| Income before income taxes | 189 | 219 | 595 | 780 |
| Provision for income taxes | 69 | 77 | 218 | 282 |
| Net income | $120 | $142 | $377 | $498 |
| Net income per share: | | | | |
| Basic | $0.63 | $0.70 | $1.93 | $2.44 |
| Diluted | $0.63 | $0.70 | $1.92 | $2.43 |
| Dividends declared and paid per share | $0.45 | $0.39 | $1.35 | $1.17 |

See accompanying Notes to Consolidated Financial Statements

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KOHL’S CORPORATION
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS’ EQUITY
(Unaudited)
(In Millions, Except per Share Data)

| | Common Stock | | Paid-In | Treasury Stock | | Accumulated Other | Retained | |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Capital | Shares | Amount | Comprehensive Loss | Earnings | Total |
| Balance at January 31, 2015 | 367 | $4 | $2,743 | (166) | $(8,744) | $(20) | $12,008 | $5,991 |
| Comprehensive income | — | — | — | — | — | 2 | 377 | 379 |
| Stock options and awards, net of tax | 3 | — | 183 | — | (26) | — | — | 157 |
| Dividends paid ($1.35 per common share) | — | — | — | — | 3 | — | (267) | (264) |
| Treasury stock purchases | — | — | — | (13) | (789) | — | — | (789) |
| Balance at October 31, 2015 | 370 | $4 | $2,926 | (179) | $(9,556) | $(18) | $12,118 | $5,474 |

See accompanying Notes to Consolidated Financial Statements

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KOHL'S CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In Millions)

| | Nine Months Ended | |
|---|---|---|
| | October 31, 2015 | November 1, 2014 |
| Operating activities | | |
| Net income | $377 | $498 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 695 | 665 |
| Share-based compensation | 36 | 38 |
| Excess tax benefits from share-based compensation | (10) | (2) |
| Deferred income taxes | (84) | (37) |
| Other non-cash revenues and expenses | 23 | 19 |
| Loss on extinguishment of debt | 169 | — |
| Changes in operating assets and liabilities: | | |
| Merchandise inventories | (1,433) | (1,093) |
| Other current and long-term assets | 74 | (1) |
| Accounts payable | 630 | 1,019 |
| Accrued and other long-term liabilities | (6) | (1) |
| Income taxes | (64) | (175) |
| Net cash provided by operating activities | 407 | 930 |
| Investing activities | | |
| Acquisition of property and equipment | (551) | (561) |
| Sales of investments in auction rate securities | — | 59 |
| Other | 3 | 6 |
| Net cash used in investing activities | (548) | (496) |
| Financing activities | | |
| Treasury stock purchases | (789) | (549) |
| Shares withheld for taxes on vested restricted shares | (26) | (17) |
| Dividends paid | (264) | (239) |
| Net borrowings under credit facilities | 400 | — |
| Proceeds from issuance of debt | 1,098 | — |
| Deferred financing costs | (10) | — |
| Reduction of long-term borrowings | (1,085) | — |
| Premium paid on redemption of debt | (163) | — |
| Capital lease and financing obligation payments | (83) | (87) |
| Proceeds from stock option exercises | 146 | 111 |
| Excess tax benefits from share-based compensation | 10 | 2 |
| Proceeds from financing obligations | 1 | 5 |
| Net cash used in financing activities | (765) | (774) |
| Net decrease in cash and cash equivalents | (906) | (340) |
| Cash and cash equivalents at beginning of period | 1,407 | 971 |
| Cash and cash equivalents at end of period | $501 | $631 |
| Supplemental information | | |
| Interest paid, net of capitalized interest | $220 | $216 |
| Income taxes paid | 370 | 493 |
| Non-cash investing and financing activities | | |

| | | |
|---|---|---|
| Property and equipment acquired through additional liabilities | $59 | $40 |

See accompanying Notes to Consolidated Financial Statements

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KOHL’S CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation
The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for fiscal year end consolidated financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. For further information, refer to the consolidated financial statements and related footnotes included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015 (Commission File No. 1-11084) as filed with the Securities and Exchange Commission on March 20, 2015.

Due to the seasonality of our business, results for any quarter are not necessarily indicative of the results that may be achieved for a full fiscal year.

We operate as a single business unit.

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606), which supersedes the revenue recognition requirements in Accounting Standards Codification ("ASC") 605, Revenue Recognition. In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which defers the effective date of ASU 2014-09 for all entities by one year. The original ASU is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Under the current pronouncements, we are required to adopt the new guidance in the first quarter of fiscal 2018 using one of two retrospective application methods. We are evaluating the application method and the impact of this new statement on our financial statements.

In April 2015, the FASB issued ASU No. 2015-03, Simplifying the Presentation of Debt Issuance Costs (Subtopic 835-30). This ASU requires an entity to present such costs on the balance sheet as a direct deduction from the related debt liability rather than as an asset. We early adopted ASU No. 2015-03 during the quarter ended August 1, 2015 and applied it retrospectively. The early adoption resulted in the reclassification of debt issuance costs from other current and long-term assets to long-term debt on the balance sheet of $18 million as of October 31, 2015, $13 million as of January 31, 2015, and $14 million as of November 1, 2014.

To conform to the current year presentation, we have corrected the presentation of $43 million of deferred income taxes that were previously recorded as long-term other assets and $24 million of income taxes payable that were previously recorded as income taxes receivable as of November 1, 2014. We also corrected the presentation of $25 million of income taxes receivable that were recorded as current other assets as of January 31, 2015.

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KOHL’S CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

2. Debt
Long-term debt, which excludes draws on revolving credit facilities, consists of the following unsecured senior debt:

| Maturity | October 31, 2015 Effective Rate | Coupon Rate | Outstanding | Outstanding January 31, 2015 | November 1, 2014 |
|---|---|---|---|---|---|
| | | | (Dollars in Millions) | | |
| 2021 | 4.81 % | 4.00 % | $650 | $650 | $650 |
| 2023 | 3.25 % | 3.25 % | 350 | 350 | 350 |
| 2023 | 4.78 % | 4.75 % | 300 | 300 | 300 |
| 2025 | 4.25 % | 4.25 % | 650 | — | — |
| 2029 | 7.36 % | 7.25 % | 99 | 200 | 200 |
| 2033 | 6.05 % | 6.00 % | 166 | 300 | 300 |
| 2037 | 6.89 % | 6.88 % | 150 | 350 | 350 |
| 2045 | 5.57 % | 5.55 % | 450 | — | — |
| 2017 | — | — | — | 650 | 650 |
| | 4.88 % | | 2,815 | 2,800 | 2,800 |
| Unamortized debt discount | | | (5) | (7) | (7) |
| Deferred financing costs | | | (18) | (13) | (14) |
| Long-term debt | | | $2,792 | $2,780 | $2,779 |

ASC No. 820, Fair Value Measurements and Disclosures, requires fair value measurements be classified in various pricing categories. Our long-term debt is classified as Level 1, financial instruments with unadjusted, quoted prices listed on active market exchanges. The estimated fair value of our long-term debt was $2.9 billion at October 31, 2015 and $3.1 billion at both January 31, 2015 and November 1, 2014.

In July 2015, we completed a cash tender offer for $767 million of senior unsecured debt. We recognized a $131 million loss on extinguishment of debt in the second quarter of 2015 which includes the $126 million bond tender premium paid to holders as a result of the tender offer and a $5 million non-cash write-off of deferred financing costs and original issue discounts associated with the extinguished debt.

Concurrent with the settlement of the tender offer, we exercised our right to redeem $318 million ($317 million, net of discount) of 6.25% notes due in 2017. The redemption was completed in August 2015 and included a $37 million "make-whole" premium and a $1 million non-cash write-off of deferred financing costs and original issue discounts associated with the extinguished debt which was expensed in the third quarter.

In July 2015, we issued $650 million of 4.25% notes due in July 2025 and $450 million of 5.55% notes due in July 2045. Both notes include semi-annual, interest-only payments beginning January 17, 2016. Proceeds of the issuances and cash on hand were used to pay the principal, premium and accrued interest of the debt which was settled in July and August 2015.

On July 1, 2015, we entered into an Amended and Restated Credit Agreement with various lenders which provides for a $1.0 billion senior unsecured five-year revolving credit facility that will mature in June 2020. Among other things, the agreement includes a maximum leverage ratio financial covenant (which is consistent with the ratio under our prior credit agreement) and restrictions on liens and subsidiary indebtedness. As of October 31, 2015, the outstanding balance on the revolving credit facility was $400 million and the effective interest rate was 1.27%. The fair value of the short-term debt under the revolving credit facility approximates its carrying value due to the short-term nature of the agreement.

## 3. Stock-Based Compensation

### Stock options

The following table summarizes our stock option activity for the nine months ended October 31, 2015:

| | Shares | | Weighted Average Exercise Price |
|---|---|---|---|
| | (Shares in Thousands) | | |
| Balance at beginning of period | 6,211 | | $52.95 |
| Exercised | (2,786 | ) | 52.88 |
| Forfeited/expired | (152 | ) | 50.32 |
| Balance at end of period | 3,273 | | $53.14 |

### Nonvested stock awards

The following table summarizes nonvested stock activity, including restricted stock equivalents issued in lieu of cash dividends, for the nine months ended October 31, 2015:

| | Shares | | Weighted Average Grant Date Fair Value |
|---|---|---|---|
| | (Shares in Thousands) | | |
| Balance at beginning of period | 2,431 | | $52.29 |
| Granted | 755 | | 69.72 |
| Vested | (886 | ) | 52.54 |
| Forfeited | (196 | ) | 54.58 |
| Balance at end of period | 2,104 | | $58.22 |

### Performance share units

During the nine months ended October 31, 2015, we granted performance-based restricted stock units ("performance share units") to certain executives. The performance measurement period for these performance share units is fiscal years 2015 through 2017. The fair market value of the grants were determined using a Monte-Carlo valuation on the date of grant. The performance share units cover a target of 153,000 shares.

The actual number of shares which will be earned at the end of the three-year vesting period will vary based on our cumulative financial performance over the vesting period. The number of performance share units earned will be modified up or down based on Kohl’s Relative Total Shareholder Return against a defined peer group during the vesting period. The payouts, if earned, will be settled in Kohl's common stock after the end of the multi-year performance period.

4. Contingencies

We are subject to certain legal proceedings and claims arising out of the conduct of our business. In the opinion of management, the outcome of these proceedings and litigation will not have a material adverse impact on our consolidated financial statements.

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KOHL’S CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

5. Net Income Per Share

The following table summarizes our basic and diluted net income per share calculations:

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | October 31, 2015 | November 1, 2014 | October 31, 2015 | November 1, 2014 |
| | (In Millions) | | | |
| Numerator—Net income | $120 | $142 | $377 | $498 |
| Denominator—Weighted average shares: | | | | |
| Basic | 191 | 202 | 196 | 204 |
| Impact of dilutive employee stock-based awards | 1 | 1 | 1 | 1 |
| Diluted | 192 | 203 | 197 | 205 |
| Antidilutive shares | 3 | 4 | 1 | 5 |

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## Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

For purposes of the following discussion, all references to "the quarter" and "the third quarter" are for the 13-week fiscal periods ended October 31, 2015 and November 1, 2014 and all references to "year to date" are for the 39-week fiscal periods ended October 31, 2015 and November 1, 2014.

The following discussion should be read in conjunction with our Consolidated Financial Statements and the related notes included elsewhere in this report, as well as the financial and other information included in our 2014 Annual Report on Form 10-K (our "2014 Form 10-K"). The following discussion may contain forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could materially differ from those discussed in these forward-looking statements. Factors that could cause or contribute to those differences include, but are not limited to, those discussed elsewhere in this report and in our 2014 Form 10-K (particularly in "Risk Factors").

### Executive Summary

As of October 31, 2015, we operated 1,166 family-focused, value-oriented department stores and a website (www.kohls.com) that sell moderately priced exclusive and national brand apparel, footwear, accessories, beauty and home products. Our stores generally carry consistent merchandise with assortment differences attributable to regional preferences. Our website includes merchandise which is available in our stores, as well as merchandise which is available only on-line.

In 2014, we introduced a multi-year strategic framework which we refer to as "the Greatness Agenda." It is built on five pillars - amazing product, incredible savings, easy experience, personalized connections and winning teams. All of the Greatness Agenda initiatives are designed to increase sales, primarily by increasing the number of customers that shop at our stores and on-line. In October 2015, we announced an evolution of the Greatness Agenda which includes both intensifying efforts on several existing priorities and introducing several new priorities. We are pleased with the positive impact the Greatness Agenda is having on our results and remain committed to the Greatness Agenda.

Driven by active and wellness initiatives, brands like Nike, Columbia, Gaiam, FitBit and Tek Gear have experienced significant growth both within the quarter and year to date. Other national brands, including Levi's and Carter's, also reported higher sales growth than the Company average for both the quarter and year to date.

We continue to build a world class digital experience to engage and empower our customers. We launched our new mobile and tablet platforms during the third quarter. In addition to driving higher conversion rates, this replatform allows our customers to utilize the buy on-line and pick-up in store ("BOPUS") functionality from these devices. Customers picking up BOPUS orders have made additional in-store purchases consistently exceeding 20% of their original BOPUS orders.

We intend to launch several new store formats in fiscal 2016. In the first half of fiscal 2016, we plan to test a new 35,000 square-foot prototype store. We believe that the smaller store will provide access to smaller markets and urban areas that wouldn't be able to support a larger store. We also plan to test 10 to 15 FILA outlet stores and two more Off-Aisle concept stores.

We continue to make progress in building and activating an unmatched personalization capability. Personalization efforts are focused on generating new customer engagement and target two growing segments of the population, Millennials and Hispanics.

We’ve expanded our localization assortment strategy. By the end of fiscal 2015, we expect approximately 40% of our sales will be transitioned to tailored assortments by store. We intend to have unique store assortments in all stores by the end of 2016.

As of October 31, 2015, approximately 34 million customers were enrolled in our Yes2You loyalty program, including 24 million who have enrolled since our national launch in October 2014. We believe that the program will be a driver of incremental traffic and sales.

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Net sales for the quarter were $4.4 billion, an increase of $53 million, or 1.2%, over the third quarter of 2014. Year to date, net sales were $12.8 billion, an increase of $131 million, or 1.0%, over 2014. Comparable sales increased 1.0% for the third quarter and 0.8% year to date.

Gross margin as a percentage of sales was 37.1% for the quarter, 10 basis points lower than the third quarter of 2014. Year to date, gross margin as a percentage of sales was 37.7%, consistent with 2014. Merchandise margin in both periods increased, but was offset by higher shipping expenses.

For the quarter, selling, general and administrative ("SG&A") expenses increased in dollars and decreased as a percentage of sales compared to third quarter of 2014. Year to date, SG&A expenses increased both in dollars and as a percentage of sales.

For the quarter, net income was $120 million and diluted earnings per share was $0.63. Year to date, net income was $377 million and diluted earnings per share was $1.92. Excluding the loss on extinguishment of debt, net income for the quarter was $144 million, an increase of 1%, and diluted earnings per share was $0.75, an increase of 7%. Year to date, excluding the loss on extinguishment of debt, net income was $484 million, a decrease of 3%, and diluted earnings per share was $2.46, an increase of 1%.

See "Results of Operations" and "Financial Condition and Liquidity" for additional details about our financial results.

Results of Operations

Net sales.

Net sales increased $53 million, or 1.2%, to $4.4 billion for the third quarter of 2015. Year to date, net sales increased $131 million, or 1.0%, to $12.8 billion. Comparable sales increased 1.0% for the third quarter and 0.8% year to date. Comparable sales include sales for stores (including relocated or remodeled stores) which were open during both the current and prior year periods. We also include omni-channel sales in our comparable sales. Adjustments for omni-channel sales that have been shipped, but not yet been received by the customer are included in net sales, but are not included in our comparable sales.

The following table summarizes changes in net sales for the quarter and year to date:

| | Quarter | | Year to Date | |
|---|---|---|---|---|
| | $ | % | $ | % |
| | (Dollars In Millions) | | | |
| Net Sales - 2014 | $4,374 | | $12,686 | |
| Comparable sales | 42 | 1.0 % | 104 | 0.8 % |
| New and closed stores and other revenues | 11 | — | 27 | — |
| Increase in net sales | 53 | 1.2 % | 131 | 1.0 % |
| Net Sales - 2015 | $4,427 | | $12,817 | |

Drivers of the changes in comparable sales were as follows:

| | Quarter | Year to Date |
|---|---|---|
| Selling price per unit | 0.5 % | 1.8 % |
| Units per transaction | 1.3 | (0.6) |
| Average transaction value | 1.8 | 1.2 |
| Number of transactions | (0.8) | (0.4) |
| Comparable sales | 1.0 % | 0.8 % |

The increases in selling price per unit were primarily due to increased penetration and selling prices in our national brand portfolio. These increases were partially offset by lower prices in our private and exclusive brands in the third quarter. The changes in units per transaction reflect customer reaction to the price changes. Generally, customers purchase more items as prices decrease and fewer items as prices increase. Transactions decreased in both the third quarter and year to date, however trends have improved since the launch of the Greatness Agenda.

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From a regional perspective, including on-line originated sales, the Southeast region outperformed the Company average for both the third quarter and year to date. The South Central region reported the largest sales declines in both the quarter and year-to-date.

For the quarter, Footwear, Men's and Women's outperformed the Company average and Children's, Home and Accessories underperformed the Company average. Year to date, Footwear and Men's outperformed the Company average and Women's and Home were consistent with the Company average. Children's and Accessories underperformed the Company average.

Gross margin.

| | Quarter | | | | Year to Date | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Increase / (Decrease) | | | | Increase | |
| | 2015 | 2014 | $ | % | 2015 | 2014 | $ | % |
| | (Dollars in Millions) | | | | | | | |
| Gross margin | $1,643 | $1,628 | $15 | 1 % | $4,827 | $4,778 | $49 | 1 % |
| As a percent of net sales | 37.1% | 37.2% | | (0.10 )% | 37.7 % | 37.7 % | | — % |

Gross margin includes the total cost of products sold, including product development costs, net of vendor payments other than reimbursement of specific, incremental and identifiable costs; inventory shrink; markdowns; freight expenses associated with moving merchandise from our vendors to our distribution centers; shipping and handling expenses of on-line sales; and terms cash discount. Our gross margin may not be comparable with that of other retailers because we include distribution center costs in selling, general and administrative expenses while other retailers may include these expenses in cost of merchandise sold.

Gross margin as a percentage of sales decreased 10 basis points for the quarter and for the year was consistent with the prior year-to-date period. Merchandise margin increased in both periods due to improved promotional markdowns. These increases were offset by higher shipping costs due to growth in our on-line business.

Selling, general and administrative expenses.

| | Quarter | | | | Year to Date | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Increase/(Decrease) | | | | Increase | |
| | 2015 | 2014 | $ | % | 2015 | 2014 | $ | % |
| | (Dollars in Millions) | | | | | | | |
| Selling, general and administrative expenses | $1,099 | $1,097 | $2 | — % | $3,120 | $3,078 | $42 | 1 % |
| As a percent of net sales | 24.8 % | 25.1 % | | (0.26 )% | 24.3 % | 24.3 % | | 0.08 % |

SG&A expenses include compensation and benefit costs (including stores, headquarters, buying and merchandising, and distribution centers); occupancy and operating costs of our retail, distribution and corporate facilities; freight expenses associated with moving merchandise from our distribution centers to our retail stores and among distribution and retail facilities; marketing expenses, offset by vendor payments for reimbursement of specific, incremental and identifiable costs; net revenues from our Kohl’s credit card operations; and other administrative revenues and expenses. We do not include depreciation and amortization in SG&A. The classification of these expenses varies across the retail industry.

The following table summarizes the changes in SG&A by expense type:

| | Quarter | Year to Date |
|---|---|---|
| | (In Millions) | |
| Corporate expenses | $19 | $57 |
| Store expenses | 13 | 42 |
| Distribution costs | (2 ) | (1 ) |
| Net revenues from credit card operations | (2 ) | (24 ) |

| | | |
|---|---|---|
| Marketing costs, excluding credit card operations | (26 ) | (32 ) |
| Total increase | $2 | $42 |

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Some of our expenses, including store payroll and distribution costs, are variable in nature. These costs generally increase as sales increase and decrease as sales decrease. We measure both the change in these variable expenses and the expense as a percent of sales. If the expense as a percent of sales decreased from the prior year, the expense "leveraged" and indicates that the expense was well-managed or effectively generated additional sales. If the expense as a percent of sales increased over the prior year, the expense "deleveraged" and indicates that sales growth was less than expense growth. SG&A as a percent of sales decreased, or "leveraged," by 26 basis points for the quarter and increased, or "deleveraged," by 8 basis points year to date.

IT spending, which is included in corporate expenses, increased as it is a continued focus of investment. Other corporate expenses also include higher incentive compensation. The increases in store expenses are a result of higher store payroll. The increases in net revenues from credit card operations are the result of higher finance charge revenues and late fees due to growth in the portfolio. Year to date, net revenues from credit card operations also increased due to lower marketing costs in the first half of 2015. Partially offsetting these increases were higher bad debt expenses and operational costs. Marketing expenses decreased for both the quarter and year to date as we were more strategic in our direct mail marketing and promotions. We plan to spend the marketing savings in the fourth quarter of 2015.

Other Expenses.

| | Quarter | | | | Year to Date | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Increase/ (Decrease) | | | | Increase/ (Decrease) | |
| | 2015 | 2014 | $ | % | 2015 | 2014 | $ | % |
| | (Dollars in Millions) | | | | | | | |
| Depreciation and amortization | $236 | $227 | $9 | 4 % | $695 | $665 | $30 | 5 % |
| Interest expense, net | 81 | 85 | (4) | (5)% | 248 | 255 | (7) | (3)% |
| Loss on extinguishment of debt | 38 | — | 38 | 100 % | 169 | — | 169 | 100 % |
| Provision for income taxes | 69 | 77 | (8) | (10)% | 218 | 282 | (64) | (23)% |
| Effective tax rate | 36.5 % | 35.3 % | | | 36.6 % | 36.1 % | | |

Depreciation and amortization increased as a result of higher IT amortization. Interest expense decreased due to our recent debt refinancing. During the third quarter of 2015, we recorded a loss on extinguishment of debt of $38 million, which represents the premium paid to bond holders related to the redemption of $318 million of 6.25% notes due in 2017 completed during the quarter and the write-off of deferred financing costs and original issue discounts associated with the extinguished debt. A $131 million loss on extinguishment was recorded in the second quarter of 2015 related to a $767 million cash tender offer. The provision for income taxes decreased due to lower income as a result of the loss on extinguishment of debt. The 2014 effective tax rates were lower than 2015 primarily due to favorable state audit settlements during the second and third quarter of 2014.

Excluding the loss on extinguishment of debt, our net income and diluted earnings per share were as follows:

| | Quarter | | | | Year to Date | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Increase | | | | Increase/ (Decrease) | |
| | 2015 | 2014 | $ | % | 2015 | 2014 | $ | % |
| | (Dollars in Millions) | | | | | | | |
| Net income | $144 | $142 | $2 | 1 % | $484 | $498 | $(14) | (3)% |
| Diluted earnings per share | $0.75 | $0.70 | $0.05 | 7 % | $2.46 | $2.43 | $0.03 | 1 % |

Seasonality and Inflation

Our business, like that of most retailers, is subject to seasonal influences, with the major portion of sales and income typically realized during the second half of each fiscal year, which includes the back-to-school and holiday seasons. Approximately 15% of annual sales typically occur during the back-to-school season and 30% during the holiday season. Because of the seasonality of our business, results for any quarter are not necessarily indicative of the results that may be achieved for a full fiscal year.

Although we expect that our operations will be influenced by general economic conditions, including rising food, fuel and energy prices, we do not believe that inflation has had a material effect on our results of operations. However, there can be no assurance that our business will not be impacted by such factors in the future.

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Financial Condition and Liquidity

The following table presents our primary cash requirements and sources of funds.

| Cash Requirements | Source of Funds |
|---|---|
| • Operational needs, including salaries, rent, taxes and other costs of running our business<br>• Capital expenditures<br>• Inventory (seasonal and new store)<br>• Share repurchases<br>• Dividend payments | • Cash flow from operations<br>• Short-term trade credit, in the form of extended payment terms<br>• Line of credit under our revolving credit facility |

Our working capital and inventory levels typically build throughout the fall, peaking during the November and December holiday selling season.

| | Year to Date | | Increase/(Decrease) in Cash | |
|---|---|---|---|---|
| | 2015 | 2014 | $ | % |
| Net cash provided by (used in): | (Dollars in Millions) | | | |
| Operating activities | $407 | $930 | $(523) | (56)% |
| Investing activities | (548) | (496) | (52) | (10)% |
| Financing activities | (765) | (774) | 9 | 1 % |

Operating Activities. Operating activities generated $407 million of cash in the first three quarters of 2015, compared to $930 million in the same period of 2014. The decrease reflects higher inventory levels and accounts payable payments, partially offset by lower tax payments.

Merchandise inventories increased $281 million over the balance at November 1, 2014 to $5.3 billion at October 31, 2015. Inventory cost and units per store both increased 5% over the third quarter of 2014, as a result of planned increases within high performing categories like active and wellness, premium electronics, entertainment and licensing, and cosmetics. The increase is primarily within national brands. Accounts payable as a percent of inventory was 40.7% at October 31, 2015, compared to 47.9% at November 1, 2014. The decrease is primarily due to earlier receipts of fall merchandise in August and September leading to higher inventory and lower accounts payable at the end of the quarter.

Investing Activities. Investing activities used cash of $548 million in the first three quarters of 2015 and $496 million in the same period of 2014. Capital expenditures were $551 million in the first three quarters of 2015 which decreased from $561 million in the same period of 2014. This decrease was driven by increases in IT and base capital spending in 2015 which were more than offset by spending on a credit call center in 2014.

Financing Activities. Financing activities used cash of $765 million in the first three quarters of 2015 and $774 million in the first three quarters of 2014.

During this year, we completed a cash tender offer and redemption for $1.1 billion of our higher coupon senior unsecured debt. We recognized a $169 million loss on extinguishment of debt which included the $163 million bond tender premium paid to holders as a result of the tender offer and redemption and a $6 million non-cash write-off of deferred financing costs and original issue discounts associated with the extinguished debt.

In July 2015, we issued $650 million of 4.25% notes due in July 2025 and $450 million of 5.55% notes due in July 2045. Both notes include semi-annual, interest-only payments beginning January 17, 2016. Proceeds of the issuances and cash on hand were used to pay the principal, premium and accrued interest of the acquired and redeemed debt which was settled in July and August 2015.

On July 1, 2015, we entered into an Amended and Restated Credit Agreement with various lenders which provides for a $1.0 billion senior unsecured five-year revolving credit facility that will mature in June 2020. Among other things, the agreement includes a maximum leverage ratio financial covenant (which is consistent with the ratio under our prior credit agreement) and restrictions on liens and subsidiary indebtedness. During the third quarter, we drew $400 million on the revolving credit facility to temporarily fund inventory purchases. As of October 31, 2015, the outstanding balance on the revolving credit facility was $400 million and the effective interest rate was 1.27%.

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We paid cash for treasury stock purchases of $789 million in the first three quarters of 2015 and $549 million in the corresponding period of 2014. Share repurchases are discretionary in nature. The timing and amount of repurchases is based upon available cash balances, our stock price and other factors.
We received proceeds from stock option exercises of $146 million in the first three quarters of 2015 and $111 million in the corresponding period of 2014. The increase is due to increases in our stock price in the first quarter of 2015, which led to an increased number of exercised options.
We paid cash dividends of $264 million ($1.35 per share) in the first three quarters of 2015 and $239 million ($1.17 per share) in the corresponding period of 2014. On November 11, 2015, our board of directors declared a quarterly cash dividend of $0.45 per common share. The dividend is payable on December 23, 2015 to shareholders of record at the close of business on December 9, 2015.
Free Cash Flow. Free cash flow is a non-GAAP financial measure which we define as net cash provided by operating activities and proceeds from financing obligation payments (which generally represent landlord reimbursements of construction costs) less capital expenditures and capital lease and financing obligations. Free cash flow should be evaluated in addition to, and not considered a substitute for, other financial measures such as net income and cash flow provided by operations.

The following table reconciles net cash provided by operating activities (a GAAP measure) to free cash flow (a non-GAAP measure).

| | Year to Date | | |
|---|---|---|---|
| | 2015 | 2014 | Increase/(Decrease) in Free Cash Flow |
| | (In Millions) | | |
| Net cash provided by operating activities | $407 | $930 | $ (523) |
| Acquisition of property and equipment | (551) | (561) | 10 |
| Capital lease and financing obligation payments | (83) | (87) | 4 |
| Proceeds from financing obligations | 1 | 5 | (4) |
| Free cash flow | $(226) | $287 | $ (513) |

Key financial ratios. Key financial ratios that provide certain measures of our liquidity are as follows:

| | October 31, 2015 | November 1, 2014 |
|---|---|---|
| Working capital (In Millions) | $2,264 | $2,421 |
| Current ratio | 1.57 | 1.66 |
| Debt/capitalization | 48.4 % | 45.1 % |
| Debt/capitalization excluding $400 million of short-term debt | 46.4 % | 45.1 % |

The decreases in working capital and the current ratio are primarily due to a $400 million draw on the revolving credit facility during the third quarter of 2015 which was used to temporarily fund inventory purchases, partially offset by higher inventories. Excluding the $400 million draw on the revolving credit facility, the debt/capitalization ratio increased primarily due to lower shareholder equity, which was primarily due to share repurchases.

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Debt Covenant Compliance. As of October 31, 2015, we were in compliance with all debt covenants and expect to remain in compliance during the remainder of fiscal 2015.

| | (Dollars in Millions) |
|---|---|
| Included Indebtedness | |
| Total debt | $ 5,158 |
| Permitted exclusions | (5 ) |
| Subtotal | 5,153 |
| Rent x 8 | 2,240 |
| Included Indebtedness | $ 7,393 |
| | |
| Rolling 12-month Adjusted Debt Compliance EBITDAR | |
| Net income | $ 746 |
| Loss on extinguishment of debt | 169 |
| Rent expense | 280 |
| Depreciation and amortization | 917 |
| Net interest | 333 |
| Provision for income taxes | 419 |
| EBITDAR | 2,864 |
| Stock based compensation | 47 |
| Other non-cash revenues and expenses | 19 |
| Rolling 12-month Adjusted Debt Compliance EBITDAR | $ 2,930 |
| | |
| Debt Ratio (a) | 2.52 |
| Maximum permitted Debt Ratio | 3.75 |

(a) Included Indebtedness divided by Adjusted Debt Compliance EBITDAR

Contractual Obligations

There have been no significant changes in the contractual obligations disclosed in our 2014 Form 10-K other than $1.1 billion of long-term debt which was refinanced in 2015 and a $400 million draw on our revolving credit facility in the third quarter of 2015. As a result of the refinancing, we have no debt due until 2021 and we expect that annual interest expense will be reduced by approximately $17 million in 2016. We expect to pay back the $400 million draw on our revolving credit facility in early December 2015.

Off-Balance Sheet Arrangements

We have not provided any financial guarantees as of October 31, 2015. We have not created, and are not party to, any special-purpose or off-balance sheet entities for the purpose of raising capital, incurring debt or operating our business. We do not have any arrangements or relationships with entities that are not consolidated into our financial statements that are reasonably likely to materially affect our liquidity or the availability of capital resources.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect reported amounts. Management has discussed the development, selection and disclosure of its estimates and assumptions with the Audit Committee of our Board of Directors. There have been no significant changes in the critical accounting policies and estimates discussed in our 2014 Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no significant changes in the market risks described in our 2014 Form 10-K.

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## Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (the “Evaluation”) at a reasonable assurance level as of the last day of the period covered by this report.

Based upon the Evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective at the reasonable assurance level. Disclosure controls and procedures are defined by Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act") as controls and other procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving our stated goals under all potential future conditions, regardless of how remote.

(b) Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended October 31, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

# PART II. OTHER INFORMATION

## Item 1A. Risk Factors

There have been no significant changes in our risk factors from those described in our 2014 Form 10-K.

Forward-looking Statements

This report contains statements that may constitute forward-looking statements within the meaning of the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Those statements relate to developments, results, conditions or other events we expect or anticipate will occur in the future. Words such as “believes,” “anticipates,” “plans,” “expects” and similar expressions are intended to identify forward-looking statements. Without limiting the foregoing, these statements may relate to future outlook, revenues, earnings, store openings, planned capital expenditures, market conditions, new strategies and the competitive environment. Forward-looking statements are based on our management’s then current views and assumptions and, as a result, are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Any such forward-looking statements are qualified by the important risk factors described in Item 1A of our 2014 Form 10-K or disclosed from time to time in our filings with the SEC, that could cause actual results to differ materially from those predicted by the forward-looking statements. Forward-looking statements relate to the date initially made, and we undertake no obligation to update them.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

We did not sell any securities during the quarter ended October 31, 2015, which were not registered under the Securities Act.

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The following table contains information for shares of common stock repurchased and shares acquired from employees in lieu of amounts required to satisfy minimum tax withholding requirements upon the vesting of the employees' restricted stock during the three fiscal months ended October 31, 2015:

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| | | | | (In Millions) |
| August 2 – August 29, 2015 | 1,481,365 | $54.72 | 1,477,407 | $ 1,020 |
| August 30 – October 3, 2015 | 2,463,692 | 49.41 | 2,460,918 | 898 |
| October 4 – October 31, 2015 | 1,020,343 | 45.75 | 957,858 | 855 |
| Total | 4,965,400 | $50.24 | 4,896,183 | $ 855 |

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Item 6. Exhibits

| Exhibit Number | Description |
|---|---|
| 3.1 | Amended and Restated Bylaws of the Company, incorporated herein by reference to Exhibit 3.1 of the Company’s Current Report on Form 8-K filed on November 13, 2015. |
| 31.1 | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Kohl’s Corporation
(Registrant)

Date: December 4, 2015

/s/ Wesley S. McDonald
Wesley S. McDonald
On behalf of the Registrant and as Chief Financial Officer
(Principal Financial and Chief Accounting Officer)