

## Panera Bread Company, Inc. Class A PNRA |

Analyst Research Analyst Report Archive Top Rated Stocks in Sector

### Panera is solidifying its position as a leader in the high-growth fast-casual restaurant category.



by  
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#### Analyst Note 10/23/2013

Like much of the restaurant category, Panera's third quarter showed a deterioration of traffic trend, though management chalked up some of the weakness to self-inflicted wounds. For the quarter, company-owned comparable sales increased 1.7% (compared with expectations of 3%-5% heading into the quarter), driven by a 2.7% increase in average check but tempered by a 1.0% decline in restaurant transactions. While we had anticipated some comp pressure due to an increasingly difficult consumer spending environment and a host of new entrants to the fast-casual restaurant category, management comments about "capacity and throughput constraints along with a less differentiated experience" raises concerns and likely explains the stock price decline this morning. Still, we believe these issues are correctable and believe our positive moat trend (which is predicated on a strengthening brand intangible asset) and longer-term growth forecasts remain

intact. This hypothesis is validated by comparable sales results that remain ahead of restaurant peers during the quarter (190 basis points ahead of the all-industry composite, according to management).

At first glance, management's fourth-quarter guidance (comp growth of 0%-2%, operating margin contraction of 100-150 basis points to 13.1%-13.6%, and EPS of \$1.91-\$1.97) and preliminary 2014 outlook (EPS growth falling below the low end of management's long-term goal of 15%-20%) seems reasonable. We plan to shave a few dollars from our \$178 fair value estimate based on tempered near-term revenue growth and margin estimates, but view shares as oversold. In our view, today's sell-off could present a buying opportunity for one of the clear leaders in the fast-casual restaurant category with strong long-term unit expansion and margin expansion opportunities as well as a commitment to enhancing shareholder value through buyback activity.

#### Investment Thesis 07/24/2013

Despite increasingly aggressive restaurant industry competition and fewer meals eaten away from home, Panera Bread Company has posted impressive operating results during the past several years. We are confident that the firm--with a record of product innovation, a compelling customer loyalty program, a pristine balance sheet, and resilient cash flows--can continue to capture incremental market share from the broader restaurant industry. Although competition has prevented Panera from fully developing an economic moat, we anticipate improving fundamentals and market share gains during the next several years.

With systemwide sales of nearly \$3.9 billion in 2012, Panera represented roughly 13% of the \$31 billion domestic fast-casual restaurant marketplace and more than half of the \$7 billion-plus domestic fast-casual bakery-cafe category. Generally speaking, we expect fast-casual restaurants--which offer higher-quality ingredients than quick-service chains but at lower average prices than casual dining restaurants--to grow nearly 10% during the next few years because of a compelling value proposition, favorable growth opportunities, and strong unit economics (lower real estate and labor costs than traditional casual dining operators). This exceeds our expectations of low-single-digit growth for the broader restaurant industry, implying incremental market share gains for Panera and other

#### Morningstar's Take PNRA

Analyst		
Price 12-16-2013	Fair Value Estimate	Uncertainty
171.56 USD	178 USD	Medium
Consider Buy	Consider Sell	Economic Moat
124.6 USD	240.3 USD	None
Stewardship Rating		
Standard		

#### Bulls Say

- We expect fast-casual restaurant category growth to outpace the broader restaurant industry during the next several years, driven by a compelling value proposition and strong unit economics.
- Panera produces stable cash flow because of long-term franchisee agreements. Franchisees typically pay more than 5% of gross sales from each bakery-cafe to the firm.
- The firm has a highly developed supply chain and an extensive fresh dough facility network, which allows for daily delivery of fresh dough to both company-owned and franchise-operated bakery-cafes.

#### Bears Say

- Fast-casual restaurant industry competition is increasing, and switching costs are virtually nonexistent. Bakery-cafe (\$7 billion-plus) and sandwich (\$4 billion-plus) concepts make up more than a third of the \$31 billion fast-casual restaurant industry.
- Uneven consumer confidence has led to volatile casual-dining guest traffic. Many casual restaurants have turned to aggressive discounting to stabilize this trend, adding another layer of competition.
- Panera and its franchisees must contend with an uneven consumer spending environment, minimum-wage hikes, and volatile commodity costs.

#### Competitors PNRA

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Name	Price	% Chg	TTM Sales \$ mil
<b>Panera Bread Company, Inc. Class A</b>	<b>\$171.47</b>	<b>1.15</b>	<b>2,295</b>
McDonald's Corporation	\$95.27	0.88	27,965
Compass Group PLC	\$15.12	0.47	27,931
Compass Group PLC	\$14.90	-1.50	27,931
Starbucks Corporation	\$76.32	-0.04	14,892
Yum Brands Inc	\$72.91	1.53	13,058

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fast-casual participants.

Given a decline in real estate and construction costs and a shakeout among local independent restaurant operators and retailers, we believe Panera has ample expansion opportunities. If the chain can match the density of its home market in St. Louis, we estimate it could ultimately expand to 4,000 domestic units. However, because of the current pace of development in the commercial real estate market, we have conservatively assumed that the chain reaches about 2,900 locations during the next 10 years. This estimate excludes acquisitions of smaller bakery-cafe chains (similar to Panera's acquisition of Phoenix-based Paradise Bakery & Cafe), accelerated international expansion, and smaller-format locations to penetrate secondary markets, each of which is possible during the next 10 years.

We consider the firm's franchised business model to be a competitive advantage. More than half of Panera's restaurants are operated by franchisees, providing the firm with an annuitylike stream of rent and royalty payments, even during difficult economic times. Additionally, the firm's vertically integrated supply chain business provides a reliable revenue source by distributing fresh dough to franchisees. As a result of these multichannel operations, Panera generates excellent free cash flow and returns on invested capital in the mid- to high teens.

After delivering lackluster results during fiscal 2006 and 2007, management streamlined its menu in an effort to simplify operating procedures at its bakery-cafes. Panera's promotions are now focused on steering customers to higher-margin products across multiple dayparts, such as breakfast sandwiches, seasonal salads, and pastas. In an effort to further boost margins, the firm also has become more selective with its real estate decisions and has taken greater opportunities to lock in prices on certain commodities. We believe these efforts have been fruitful, as evidenced by impressive operating margin expansion gains during the past several quarters despite contending with elevated food costs. We also view Panera's efforts to improve throughput during peak hours (through physical capacity expansion, new production processes/tools, reduced product complexity, and improved enterprise systems) as positive investments that should improve store-level productivity over time.

Despite their positives, even well-managed restaurant chains are susceptible to unfavorable industry conditions, including consumer spending headwinds and volatile food commodity, labor, and occupancy costs. Given the fast-casual restaurant category's compelling unit economics, we expect increased category competition during the next several years (including existing quick-service and casual-dining restaurant operators), forcing firms to increasingly compete with one another for share. Additionally, with retail landlords looking for tenants for unoccupied real estate and restaurant operators finding themselves with easier access to capital in recent months, we believe new fast-casual restaurant entrants will increasingly come to the market. However, we believe Panera can weather economic and competitive pressures effectively thanks to its strong customer loyalty, upscale restaurant environments, and continuous menu innovations.

#### **Economic Moat** 07/24/2013

Nonexistent switching costs, intense industry rivalry, and low barriers to entry make it difficult for restaurant operators to establish an economic moat. Even with Panera's leadership in the fast-casual restaurant category, we do not think the firm has fully developed the scale or brand recognition necessary for an economic moat. Panera generated \$3.9 billion in systemwide sales during 2012 (combined sales at company-owned and franchise units), a fraction of the systemwide sales for established-moat restaurant chains such as McDonald's (\$88 billion in 2012) and Yum Brands (\$43 billion). Furthermore, Panera's early success and compelling unit economics have not gone unnoticed, spawning multiple rivals with aggressive growth aspirations within the fast-casual sandwich and bakery-cafe restaurant categories. It is also unclear whether Panera will be able to successfully replicate its restaurant format outside of North America. Still, if Panera maintains its current momentum and demonstrates the ability to preserve market share from a host of new fast-casual rivals, we'd consider awarding Panera a narrow economic moat



rating based on the strength of its brand intangible asset.

#### **Valuation** 07/24/2013

We are lowering our fair value estimate to \$178 per share from \$182 per share owing to near-term expectations of softer consumer spending, aggressive industry promotional activity, and increased competition. Our revised fair value estimate implies 23 times our 2014 EPS estimate, an enterprise value that is 11 times our 2014 EBITDA estimate, and a free cash flow yield of about 3.5%.

In our view, management's full-year 2013 top-line goals, including 3%-5% company-owned comparable-unit sales growth and 125 or more new system unit openings (representing approximately 7% growth), strike us as reasonable targets that should drive low double-digit top-line growth for the year. We believe Panera will maintain low-single-digit comparable sales growth in the back half of 2013--a modest decrease from previous estimates due to macro, industry, and competitive factors--but expect a rebound in 2014 through restaurant productivity efforts such as investments to improve peak-hour throughput, drive-thru locations, table delivery tests, higher-ticket signature items, a meal upgrade program offering small bakery attachment items, and catering services. Over the next decade, we expect Panera to open 120-130 units per year (representing mid-single-digit annual unit growth) and post mid-single-digit comps, resulting in low-double-digit average annual revenue growth. These assumptions imply there will be more than 2,900 Panera locations by 2022.

We also believe management's 2013 goal of flat operating margin improvement (implying full-year margins around 13.3%) looks realistic based on year-to-date restaurant margins but is tempered by peak-hour throughput and other informational technology investments in the back half of the year as well as modest operating expense deleverage based on our updated comparable-unit sales growth estimates. Our base-case model assumes fiscal 2013 operating margins of 13.3%. Panera's EPS implied forecast of \$6.75-\$6.85 (representing 15%-16% growth year-over-year) also achievable, especially after factoring in share repurchases. Over the next decade, we expect restaurant-level margins to grow to the 22%-23% range (compared with 20.2% in 2012) with operating margins to expanding to approximately 17% as higher-margin menu additions, increased fixed-cost leverage, a vertically integrated supply chain, and a moderate shift toward franchised bakery-cafes should offset ongoing marketing and infrastructure investments.

#### **Risk** 07/24/2013

Panera faces increased competition on several fronts. Some quick-service restaurant chains are upgrading their menus and decor, while many casual dining firms have become more focused on enhancing their value proposition. Additionally, with retail landlords looking for tenants for unoccupied real estate and restaurant operators finding themselves with easier access to capital in recent months, we believe new fast-casual restaurant entrants will increasingly come to the market in the months to come. If its brand appeal isn't as wide as we believe, Panera could face market saturation sooner than anticipated. Demographic shifts, an increasing number of meals prepared at home, and ongoing consumer spending headwinds could damp top-line results. Food, labor, energy, and occupancy cost volatility could disrupt quarter-to-quarter results.

#### **Management** 05/20/2013

In April 2013, Panera announced that co-CEO Bill Moreton would transition to executive vice chairman effective August 2013 because of his need to spend more time on an undisclosed family matter. Co-CEO Ron Shaich, who came out of retirement in March 2012, will become Panera's sole CEO at this time. Although we'd prefer a bit more stability at the CEO level, we do not expect any disruptions under this leadership arrangement. In general, we believe Panera's strategic planning and corporate oversight are on solid footing.

In fiscal 2012, Moreton earned a total compensation package of \$3.7 million (including a base salary of \$629,900, an annual incentive bonus of \$945,500, stock awards worth an estimated \$945,400, and nonequity incentive plan compensation of \$1.1 million), which seems reasonable compared with Panera's peer group. Shaich earned \$4.4 million in fiscal 2012 (a base salary of \$626,300, an annual incentive bonus of \$945,500, stock awards worth an estimated \$945,400, and nonequity incentive plan compensation of \$1.9 million), which also strikes us reasonable in light of Panera's strong financial performance the past several years. As of the most recent proxy statement, Shaich owned 4.5% of Panera's Class A shares and 84.2% of its Class B shares (representing 11.1% of the combined voting power), which is sufficient to align his interests with common shareholders, in our view. Although we hold the executive management team in high regard, we believe corporate stewardship could be improved by the elimination of measures to limit the powers of outside shareholders, including the dual-class structure, staggered board elections, and other takeover defenses. Still, with a strong track record of capital allocation including making acquisitions at reasonable prices (traditionally between 5 and 6 times trailing EBITDA) and prudent share repurchase activity, we've assigned Panera a standard stewardship rating.

## Overview

### Profile:

Panera Bread is the largest player in the \$7 billion-plus fast-casual bakery-cafe restaurant category. The company owns and franchises bakery-cafes under the Panera Bread, Saint Louis Bread Co., and Paradise Bakery brands, specializing in baked goods, sandwiches, soups, salads, and custom-roasted coffees. Locations are primarily in suburban strip malls and regional malls across the United States. As of June 2013, the firm had more than 1,700 bakery-cafes, including 835 company-owned and 873 franchised locations.

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