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PANERA BREAD COMPANY

As the end of 2007 drew near, Panera Bread Company was facing a brand-new challenge. Until recently, strong margins had allowed Panera to finance its rapid growth largely through retained earnings and very minor equity infusions resulting from compensation programs. The company used no permanent debt financing and, in fact, had allowed a $10 million dollar credit facility to expire. But now Panera was facing a decline in margins that would limit its ability to rely on internal funds. With growth expected to continue and a $75 million stock repurchase under consideration, the company realized it would almost surely need capital from external markets—in both the short run and the long run.

History and Business Model

Panera Bread Company had its origins in another successful bread venture, Au Bon Pain Co., which was founded in 1981. The success of Au Bon Pain in the 1980s gave rise to the 1993 purchase of Saint Louis Bread Company, a small bakery-café company located in St. Louis, Missouri. By the end of 1999, the Saint Louis Bread Company concept was being expanded under the Panera Bread name, Au Bon Pain had sold off all its units except Panera Bread, and Au Bon Pain itself had adopted the Panera name.

The goal of Panera Bread Company was to create a dining experience centered on fresh-baked bread in an environment where people "slowed down to enjoy real food."[1] Its emphasis on wholesome foods and a welcoming environment placed the company in stark contrast to the fast-food experience that dominated the multiunit restaurant business. An essential element was a commitment to high-quality bread. Panera breads were baked fresh every day, at every location. The bread was featured in virtually all the store offerings, including such selections as made-to-order sandwiches and soup served in a bread bowl.

Ensuring high-quality bread required the best ingredients, specialized equipment, and careful training. For example, Panera baked its breads on heated stone slabs in European-style

[1] Panera Bread Company annual report, 2006.

ovens. Customers appreciated the results—Panera consistently earned recognition for the quality of its offerings, often attaining the top position in customer-satisfaction surveys. The essential business model, therefore, was to provide a meal and dining environment of sufficient high quality that customers would gladly pay for that quality—at a price that would also make the company financially successful.

The success of this business model was readily apparent. Starting with just 20 stores in 1993, the firm had more than 1,000 locations across 38 states by the end of 2006 operating under the Panera Bread and Saint Louis Bread Co. names.[2] During 2006 alone, the company increased its number of outlets by 17% and attained more than 4% same-store sales growth. For the three years ending in 2006, total revenues grew an average of 32% a year with operating profit to sales averaging 12%.[3]

Recent Challenges

A key measure of success in the restaurant business was transaction growth—the increase in same-store sales ignoring the effect of price increases. Transaction growth at the start of 2007, continuing a trend from the very end of 2006, was lower than anticipated. In addition, margins for 2006, while strong, were down slightly from the previous two years (financial statements for 2003 to 2006 are presented in **Exhibits 1** and **2** with a forecast of operating results for 2007 presented in **Exhibit 3**) and were expected to be lower in 2007. These problems were not unique to Panera. Commodity costs, particularly wheat, had risen, and cost uncertainty was a concern for the entire restaurant industry.[4] To drive transaction growth for the future, the company might need to back off on price increases even in the face of rising costs. In other words, to sustain the firm's growth, Panera might have to operate at tighter margins.

Furthermore, as a result of tightening margins, uncertain costs, and a softening in transaction growth in 2007, Panera's stock price had dropped a precipitous 10% on the announcement of third-quarter results and was down almost 40% over the past year (**Exhibit 4** presents recent stock price data). In response, the firm was considering a $75 million dollar stock repurchase. As JPMorgan analyst Steven Rees observed, the repurchase would signal management's position on the "long-term potential of the business as well as many company-specific near-term initiatives to drive sales and margin improvements."[5]

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[2] http://www.panerabread.com/about/press/kit/ (accessed October 7, 2008).

[3] Panera Bread Company annual report, 2006.

[4] Melanie Lindner, "Panera: This Bread is Not Rising,"*Forbes.com* Market Scan, October 24, 2007 (accessed October 6, 2008).

[5] Melanie Lindner, "Panera Bread Leavening," *Forbes.com*, Market Scan, November 28, 2007.

Financing

In the past, Panera had financed growth through retained earnings and through the modest increases in equity capital that resulted from the exercise of stock options and employee stock ownership plans. In effect, there had been little reliance on external capital.[6] This reluctance to assume debt was typical of some, but not all, competitors (**Exhibit 5** presents capital structure information for a variety of dining companies). As 2007 drew to a close, however, Panera Bread Company was clearly stuck between a rock and a hard place. Raising prices to improve margins would stymie company growth and likely precipitate a further decline in the firm's stock price. Accepting tighter margins would allow growth but limit the ability of internally generated funds to finance that growth. Adding to this conflict was the need to raise funds to make the stock repurchase. In the end, it was clear that Panera would have to consider, for the first time, accessing external capital markets. The real question was how much, what kind, and when.

[6]The company did have small, occasional borrowings. These were not outstanding at year end and were the reason the company showed small amounts of interest expense.

Exhibit 1

PANERA BREAD COMPANY

Historic Income Statements
(in thousands of dollars)

	2003	**2004**	**2005**	**2006**
Number of bakery cafés[(a)]	602	741	877	1,027
Revenue	363,702	479,139	640,275	828,971
Costs of goods sold				
Bakery-café	210,822	288,706	399,760	542,916
Dough sold to franchisees	54,967	65,627	75,036	85,618
Depreciation	18,304	25,298	33,011	44,166
General and administrative[(b)]	31,502	38,735	50,240	63,502
	315,595	418,366	558,047	736,202
Operating profit	48,107	60,773	82,228	92,769
Interest expense	48	18	50	92
Pretax profit	48,059	60,755	82,178	92,677
Tax	17,629	22,175	29,995	33,827
Net income	30,430	38,580	52,183	58,850

[(a)] Includes both company-owned and franchised bakery-cafés.
[(b)] Includes preopening expenses and other expenses.

Data source: Panera Bread Company annual reports, 2003–06.

Exhibit 2

PANERA BREAD COMPANY

Historic Balance Sheets
(in thousands of dollars)

Historic Balance Sheets:

	2003	**2004**	**2005**	**2006**
Cash and short-term investments	51,421	58,054	60,651	72,122
Accounts receivable	12,394	17,256	25,158	30,919
Inventory	4,350	5,398	7,358	8,714
Prepaid expenses and deferred taxes	3,887	3,905	9,607	15,863
Current assets	72,052	84,613	102,774	127,618
Property, plant, and equipment	146,362	201,725	268,809	345,977
Goodwill and other assets	38,421	38,334	66,084	69,014
Total assets	256,835	324,672	437,667	542,609
Accounts payable	8,072	5,840	4,422	5,800
Accrued expenses and deferred revenue	37,571	49,865	82,443	103,810
Current liabilities	45,643	55,705	86,865	109,610
Deferred rent and other liabilities	13,616	27,604	33,824	35,333
Total liabilities	59,259	83,309	120,689	144,943
Equity	197,576	241,363	316,978	397,666
	256,835	324,672	437,667	542,609

Data source: Panera Bread Company annual reports, 2003–06.

Exhibit 3

PANERA BREAD COMPANY

2007 Operating Forecast[a]
(in thousands of dollars)

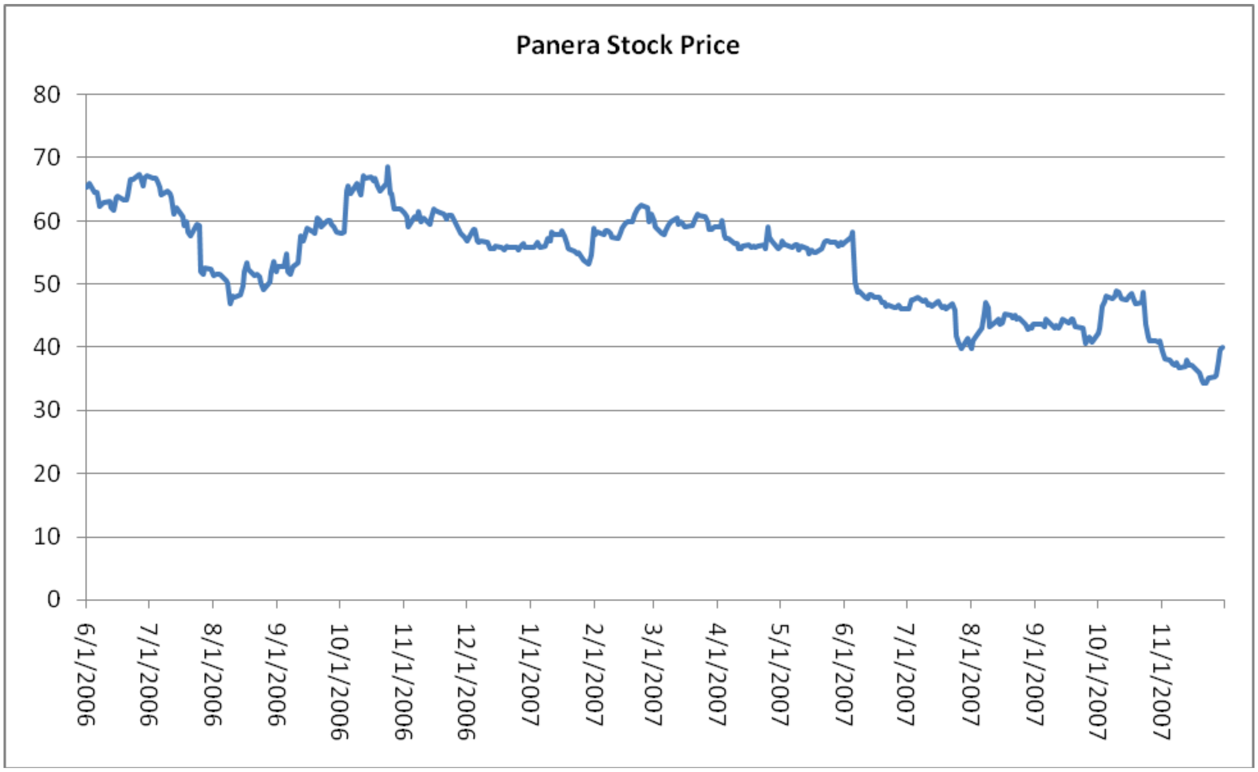
Number of Bakery Cafés[b]	1,230
Revenue	1,050,000
Costs of goods sold	
Bakery-café	738,000
Dough sold to franchisees	86,000
Depreciation	60,000
General and administrative[c]	78,000
	962,000
Operating profit	88,000
Interest expense	150
Pretax profit	87,850
Tax	31,500
Net income	56,350
Current assets	150,000
Property, plant, and equipment	430,000
Goodwill and other assets	110,000
Total assets	690,000
Current liabilities	130,000
Deferred rent and other liabilities	45,000
Total liabilities	175,000

[a] Case writer estimate based on third quarter results.
[b] Includes both company-owned and franchised bakery-cafés.
[c] Includes preopening expenses and other expenses.

Exhibit 4

PANERA BREAD COMPANY

Stock Price History



Data source: Datastream.

Exhibit 5

PANERA BREAD COMPANY

Data on Comparable Firm Capital Structure

	Estimates for Year-End 2007			11/30/2007	
	Revenue	**EBIT**	**LT Debt**	**Price**	**Shares**
Quick Service Restaurants					
McDonald's Corp	22,786,600	3,879,000	8,174,500	56.32	1,165,300
Wendy's Group Inc.	1,263,717	19,900	739,333	8.10	28,884
Burger King Holdings Inc.	2,234,000	290,000	943,000	25.90	135,000
Domino's Pizza, Inc.	1,462,870	193,910	1,720,083	13.86	59,665
Jack in the box Inc.	2,513,431	216,996	433,303	29.95	59,736
Casual Dining					
Darden Restaurants Inc.	5,567,100	574,400	491,600	38.25	141,400
Ruby Tuesday Inc.	1,410,227	154,855	514,338	13.11	53,240
PF Chang's China Bistro Inc.	1,084,193	53,312	191,195	25.59	24,152
The Cheesecake Factory Inc.	1,511,577	110,803	175,000	23.29	69,152
California Pizza Kitchen Inc.	632,884	21,517	0	15.91	28,358
Fast Casual					
Chipotle Mexican Grill, Inc.	1,085,782	113,706	0	133.15	32,805
Starbucks Corp.	9,411,497	1,053,945	550,000	23.39	727,600
Buffalo Wild Wings Inc.	329,652	28,518	12,585	28.91	17,657

Data sources: Investex, Onesource, Yahoo! Finance, and individual firm 10-K filings.