Buffalo Wild Wings (NASDAQ: BWLD)

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0. Preamble

This is my write-up on Buffalo Wild Wings, some portions of the company and industry data is gleaned from a school assignment I wrote in Feb. The valuation and Margin of safety is current. The information and data comes from Morningstar, various research reports and websites. You can send me an email feedback at raytoei@gmail.com 31st May Sunday

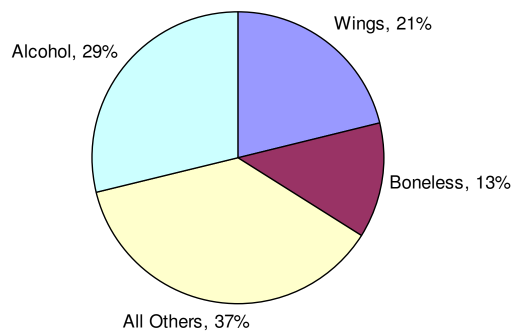
1. Is this a good business run by smart people?

Company Background and Business Overview

Buffalo Wild Wings (BWLD) owns, operates and franchises a chain of casual restaurants serving Buffalo-style chicken wings in a variety of hot sauces and an array of alternative menu items including bottled beers, wine and liquor. The restaurant concept is a mixture of causal dining and fast casual dining, packaged in a sports theme concept. It features counter food as well as table service. Started in 1982 as a single restaurant by two entrepreneurs in Columbus, Ohio, the company was publicly listed in 2003 under the NASDAQ ticker BWLD.

In the most recent quarter, Buffalo Wild Wings owned 197 restaurants with 364 franchise stores across 40 states. Half of restaurants are concentrated in six states, Ohio, Michigan, Indiana, Illinois, Wisconsin, Minnesota and Texas. The restaurants have an average size between 4,500 to 6000 square feet, and are filled with 40 TV screens and 2 projection screen, and gaming consoles.

Sales Mix 2008



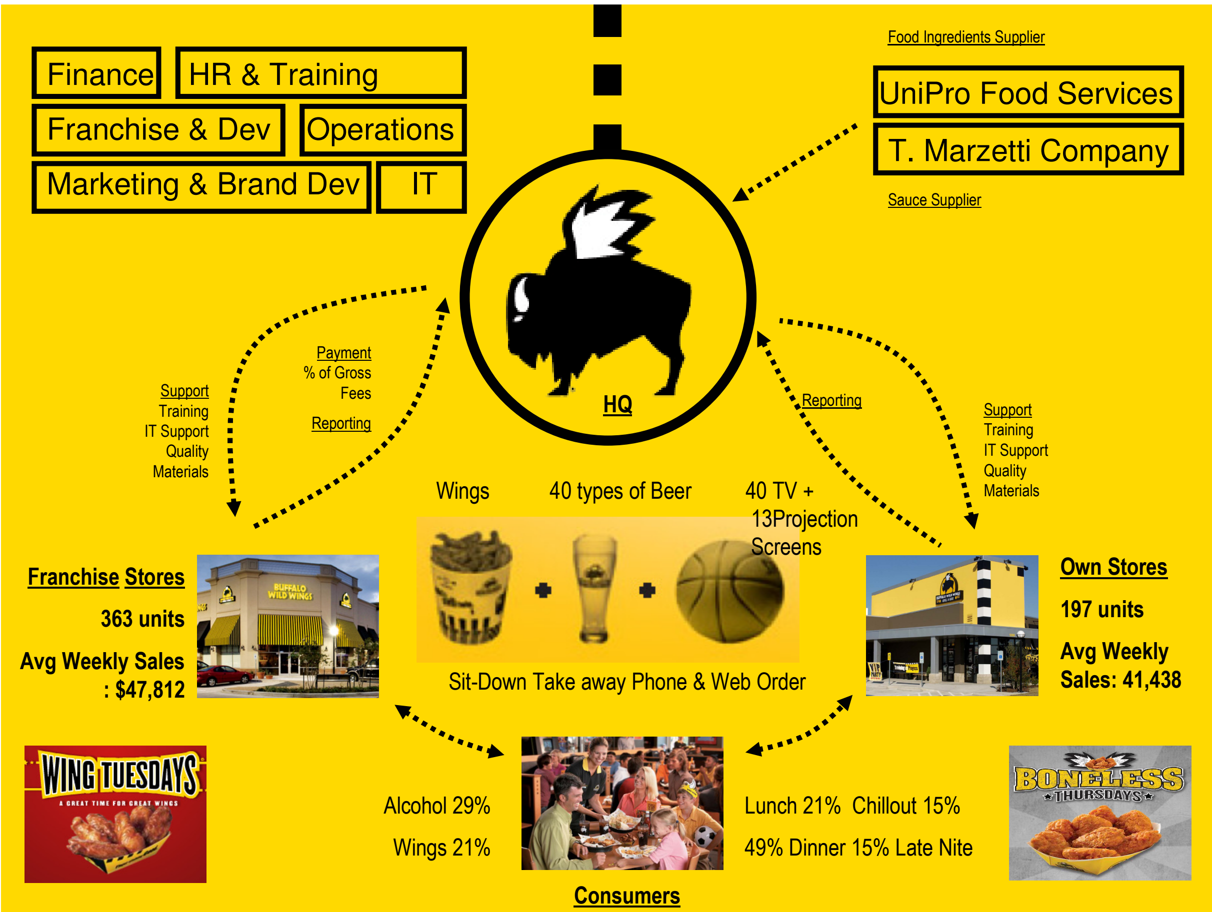
(Source: KeyBanc Capital Research Feb 2009)

In the most recent quarter, wings represented 21% of menu sales on average while boneless chicken items like sandwiches and tenders were 14%, and alcohol was 29%, with other items at 37%. While the demographic was predominantly male, it has successfully branched into the family dinner as well as the lunch-time business crowd, 15% of sales occur during 2pm to 5pm while an additional 15% occurs from 9pm to close of business, dinner customers represented 49% of sales.

BWLD does well during sport seasons and the company drives customer traffic through community marketing campaigns that promote local sports teams. In addition, the company spends 3% of sales in advertising during sports events such as NFL games, college football, NASCAR events. The combination of tasty inexpensive menu items served in a lively environment has resulted in a loyal clientele with a brand that is growing.

The company has experienced aggressive growth in the past five years since it went public in 2003, sales has been accelerating at 28% annually as the company grew regionally.

From the 2008 annual report, the company seeks to grow to 1,000 outlets as it expands nationally. Despite the recent economic slowdown, the company has held on to the stated aim on opening 15% more outlets in 2009 while not compromising its earnings and revenue growth goals. Financially, the company generates healthy cash flow, and is free of long-term debts. Franchise stores produces higher average sales volume of USD 2.5m in 2008, 13% more than the company owned stores.



BWLD compares itself against national restaurant chains such as Friday's, Ruby's, Chili's and Applebee's. However, BWLD's growth has not gone unnoticed, new entrants include Champps Entertainment, Jillian's Entertainment, Wingtop Restaurant and Slaymaker Group Inc.

The restaurant concept has a wide appeal, and BWLD has won numerous "Best Wings" and "Best Sports Bar" awards across the country. BWLD is consistently on the top 10 list of the highly quoted Technomic Top 100 Fastest Growing Restaurant chain since 2003. It has also appeared consistently on the Franchise 500 list:

Year	**Franchise 500 rank**	**Fastest Growing Franchise Rank**
2009	#87	#62
2008	#115	-
2007	#85	#83
2006	#96	#88
2005	#122	#98

(Source: www. entrepreneur.com)

** Industry Analysis (Pls Refer to Appendix II on the Restaurant Industry)

Porter's Five Forces

OVERALL INDUSTRY RATING	**Favorable**	**Moderate**	**Unfavorable**
1. Threat of New Entrants	4	1	7
2. Bargaining Power of Buyers	4	1	5
3. Threat of Substitutes	1		3
4. Bargaining Power of Suppliers	1		6
5. Intensity of Rivalry Among Competitors	3		6

From the P5F analysis, the industry profile can be generalized: The industry has a low barrier of entry to new entrants, customers have moderate bargaining power although branding is a strong differentiator, and substitutes do exist from customers who can choose to cook at home, the industry has a few large suppliers with strong bargaining power. The rivalry among competitors is intense and this makes it hard to earn above average profits.

(Please refer to the Appendix for the full ranking with comments)

TOWS Analysis

Opportunities (Industry specific)

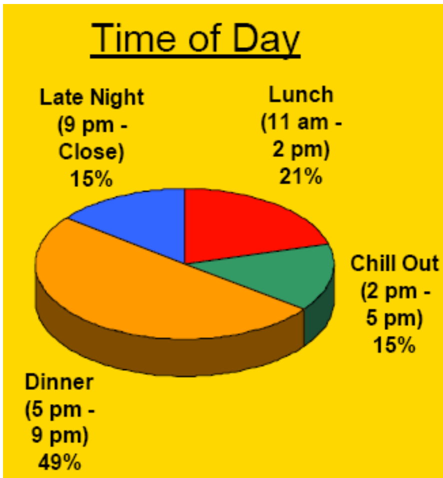
- Increased Boomers (45 to 64 yrs) dining out
- Increased social activity in eating out (aka "The Third Place" effect)
- Increasing trend towards convenience
- Increasing adoption of U.S. fast food diet world wide
- Increasing usage of multiple delivery channels
- Increasing trend of ethnic and themed food
- Increasing trend towards healthier food

Threats (Industry specific)

- Decreasing spending due to Recession
- Increased competition from other social activities
- Food choices are increasingly becoming indistinguishable
- Increased competition in the restaurant business
- Increasing costs in commodity prices
- Increasing awareness of health scare by avian or mad cow disease
- The industry is increasingly being regulated
- Increasing trend towards healthier food

Strengths (BWLD specific)

- A winning formula in the new Fast Casual segment
- Highly innovative product development
- Popular weekly promotions
- Strong regional brand recognition
- Ability to pass cost onto consumers
- Strong management team
- Strong financials



Weaknesses (BWLD specific)

- Limited operating history as a Public company
- Small national advertising budget
- Highly dependence on sports season
- Weaker Lunch time sales
- Diminishing Free cash flow as company expands

FCF	2008	2007	2006	2005
BWLD	-1	2	9	3

Management

In 1995, the company was running out of cash while getting into troubles with the IRS and its creditors, the company hired Sally Smith, a CPA by training as CFO. After several successful years, she was appointed as chief executive in 1996 and has stayed in that position since. Most of the senior management team has been in the company for at least 5 to 10 years. The role of the CEO is separate from the Chairman and six out of seven board directors are independent.

Current	Past
Sally J. Smith Chief Executive Officer and President since 1996.	She served as our Chief Financial Officer from 1994 to 1996.Prior to joining Buffalo Wild Wings, she was the Chief Financial Officer of Dahlberg, Inc., the manufacturer and franchisor of Miracle-Ear hearing aids, from 1983 to 1994
Judith A. Shoulak, 48 SVP, Operations since March 2004	SVP of Human Resources from January 2001 to February From 1993 to 2001, Ms. Shoulak served as VP of Field Human Resources of OfficeMax.
James Schmidt, SVP, General Counsel and Secretary since 2002	Mr. Schmidt has also served as our Secretary since September 2002, and he served as a director on our Board from 1994 to September 2003.Mr. Schmidt has been a practicing attorney since 1985.
Mary Twinem EVP, CFO and Treasurer	Served as our Executive Vice President, Chief Financial Officer and Treasurer since July 1996.She served as our Controller from January 1995 to July 1996.
Linda Traylor SVP, Human Resources since 2006.	Prior to joining us, Ms. Traylor managed her own consulting company, LG Traylor & Associates from 2005 to 2006.From 2001 to 2005, Ms. Traylor served as SVP, Human Resources of Denny's Corporation and as its VP, Human Resources Planning and Development from 1995 to 2001
Mounir N. Sawda SVP, Franchise & Development since 2007.	Prior to joining the company, Mr. Sawda managed his own consulting company from 2005 to 2007. From 1998 to 2005, Mr. Sawda served in various executive positions at Denny s Corporation, most recently as VP Development.
Kathleen M. Benning SVP, Marketing and Brand Development since 2002.	She joined the company in March 1997 as VP of Marketing. From 1992 to 1997, Ms. Benning was employed by Nemer, Fieger & Associates, an advertising agency, where she was a partner from 1994 to 1997.

Insider currently own about 6.71% % of the company, I see this as a positive, as management have an incentive to align with the shareholders, however in the last six months, management has been selling in the open market about $1.8m of BWLD stock at an average price of $34. While I believe the management is taking a long term view of BWLD, perhaps the selling of shares is an indication of the share price appreciation in since the Nov 2008 swoon.

(http://www.secform4.com/insider-trading/1062449.htm)

Financial Ratio Analysis

No	Ratio	BWLD	Chili's	Red Lobster	Applebee's
1	Sales Growth% (CAGR Last 3 years)	24.50%	0.80%	3.63%	6.80%
2	Unit Growth % (CAGR Last 3 years)	15.8% (YoY)	11.00%	0% (680 flat)	NA
3	Same Store Sales Growth% (Year on Year)	6.83%	-2.40%	1.10%	NA
4	Gross Margin% (Avg 3 yrs)	72.40%	72.00%	22.80%	21.30%
5	Operating Margin% (Avg 3 yrs)	7.9%	7.17%	8.47%	10.57%
6	Debt / Equity (Latest)	0	1.29	1.22	0.22
7	Quick Ratio = (CA- Inv)/(CL)	1.45	0.578	0.175	0.612
	Other Metrics	**BWLD**	**Chili's**	**Red Lobster**	**Applebee's**
A	% Restaurant company owned	35.10%	61%	100.00%	26.10%
B	Restaurants total (Franchise + Company)	561	1487	680	1943
C	Average Sales per restaurant	2.1m	3.2m	3.8m	2.63m
D	Average Check per person	$12.50	$12.93	$18.50	12.50
E	% Alcohol of sales	29%	13%	7.80%	12%
F	% Take-away of Sales	17.00%	10.00%	3.30%	9.40%

(Source: Research reports on individual companies)

Analysis:

BWLD is an upstart compared to Chili’s, Red Lobster or Applebee’s, while it is much smaller in terms of revenue, and number of restaurants units, it’s growth rates are impressive, revenue growth, unit growth experienced double digit growth in the past three years.

Same store sales are much higher than the more mature competitors, this is also seen in the average sales per restaurant where it is only $2.1m as compared with the high of $3.8m for its peer group Red Lobster, generally, this means that BWLD can still continue to grow the SSS and average sale per restaurant.

BWLD has a higher alcohol mix (29%) which is quite uncharacteristic of the Casual dining, more oftenly seen in high casual / fine dining. The high take-away reflects the Fast Casual hybrid nature of the business, where business is done at the counter and the company promotes convenience as well as full service.

Summary: BWLD fits the profile of a well run company growing aggressively while taking market share from other companies in the slow growth industry. It funnels it cash generated to grow more restaurant, and it is executing this plan without taking on debt.

iii. ROE Decomposition for BWLD

2002	2003	2004	2005	2006	2007	2008	TTM	Profitability
6.1	2.8	6.5	7.0	11.1	11.0	11.1	11.7	Return on Assets %
15.1	4.5	9.0	9.7	15.3	15.2	15.6	16.0	Return on Equity %
3.2	1.7	4.2	4.2	5.8	6.0	5.8	5.8	Net Margin %
1.89	1.63	1.53	1.66	1.89	1.84	1.92	2.02	Asset Turnover
2.5	1.4	1.4	1.4	1.4	1.4	1.4	1.4	Financial Leverage

Analysis of historical trends

ROE = Net Margin x Asset Turnover x Financial Leverage

The BWLD ROE shows an impressive trend, ROE has been increasing steadily because of improvement in margins and asset turnover; it generates sales of $1.92 for every dollar of assets. This is done while financial leverage is held constant (asset / debt). BWLD has no long term liabilities.

Comparison with ROE with Peers,

Brinkers (Chili's)

1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	TTM	Profitability
7.6	10.5	11.2	9.5	9.1	7.4	7.3	9.7	10.1	2.3	1.7	Return on Assets %
12.6	16.6	17.5	16.3	15.9	14.2	15.1	19.5	24.5	7.4	5.9	Return on Equity %
4.2	5.5	5.9	5.3	5.1	4.2	4.1	5.1	5.3	1.2	0.9	Net Margin %
1.80	1.92	1.90	1.79	1.76	1.78	1.79	1.90	1.93	1.88	1.83	Asset Turnover
1.6	1.5	1.6	1.8	1.7	2.2	2.0	2.1	2.9	3.7	3.3	Financial Leverage

AppleBee's

1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	TTM	Profitability
13.0	11.3	11.4	13.8	13.3	15.6	15.5	15.9	12.5	8.9	7.3	Return on Assets %
16.9	17.1	19.7	23.6	21.2	23.1	21.9	23.2	22.4	18.0	12.3	Return on Equity %
8.7	7.7	8.1	9.2	8.7	10.0	9.4	10.0	8.4	6.0	5.0	Net Margin %
1.49	1.46	1.41	1.51	1.53	1.55	1.64	1.59	1.49	1.48	1.46	Asset Turnover
1.3	1.7	1.7	1.7	1.5	1.4	1.4	1.5	2.1	1.9	1.7	Financial Leverage

Darden (Red Lobster)

1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	TTM	Profitability
7.2	9.1	9.4	10.0	8.9	8.5	10.2	11.4	6.8	9.9	9.2	Return on Assets %
14.2	18.4	19.7	22.0	20.0	19.0	23.1	27.0	17.3	30.1	28.0	Return on Equity %
4.1	4.8	4.9	5.4	5.0	4.6	5.5	5.9	3.6	5.7	5.0	Net Margin %
1.78	1.91	1.92	1.84	1.79	1.84	1.85	1.92	1.89	1.74	1.86	Asset Turnover
2.0	2.0	2.1	2.2	2.2	2.2	2.3	2.5	2.6	3.4	3.4	Financial Leverage

Source: Morningstar

The ROE of BWLD is the lower than its peers except for Chili's for 2008, however, a better comparison would be against Applebee's 18% ROE since Red Lobster and Chili's deploy's a lot of leverage to magnify the ROE. BWLD does not use debt, this is a prudent discipline as a result of the company's financial troubles in the mid-80s. Red Lobster and Chili's are mature companies and stable cash flows, hence it is confident of such high debt to equity ratios (Financial leverage around 3)

iv. Free Cash Flow

Free Cash Flow 'Millions	2008	2007	2006	2005	Dividend Yield %
BWLD	-1	2	9	3	0
Chili's	91	54	116	109	3.3%
Red Lobster	NA	225	379	254	2.7%
Applebee's	NA	80	52	82	8.6%

BWLD has been able to grow aggressively while not sacrificing its margins, the operating margins is only slighly lower than the more mature and stable competitors. BWLD is using its operating cash flow to build more restaurant units, thus it has a lower free cash flow than its peers. Unlike the more mature restaurants, BWLD does not issue a dividend.

2. What is the company worth?

I. Asset Based Tool (Based on Discounted Cash Flow)

I am going to model 2 scenarios; the first assumes that we follow BWLD Management's guidance of 20% long-term earnings growth (and 25% revenue growth). I refer to this long term as 10 years. While this may look overly optimistic, BWLD's previous years of EPS growth have been impressive with 1yr, 3yrs and 5yrs coming in at 23.6%, 38.7% and 37.7%. During the most recent quarter, it has reaffirmed this year's EPS growth of 20%.

And the second scenario assumes a more conservative growth rate of growing EPS at 15% for the next 5 years followed by another five years of 10% and a long term rate of 5%. (following the restaurant industry long term trend).

Assumptions: Discount rate of 15% to denote the expected rate of return I expect from this small cap.

Mgmt Guidance Growth: EPS growth rate of 20% for 5 years, followed by 20% for another 5 years with a terminal growth rate of about 5%

Conservative EPS Growth rate: 15% for the next five years, followed by 10% for the next five years and a long term growth rate of 5%. This is conservative estimate for a growth stock.

Mgmt Guidance Scenario

Ticker	BWLD		%
		Growth (Y1 to 5)	20.00
Free Cash Flow	1.46	Growth (Year 6 to 10)	20.00
SharesOut	1	Discount Rate	15.00
Long Term Debt	0.00	Long Term Growth Rate	5.00
		Long Term Discount Rate	15.00
DCF-IV	**42.05**		

Conservative

Ticker	BWLD		%
		Growth (Y1 to 5)	15.00
Free Cash Flow	1.46	Growth (Year 6 to 10)	10.00
SharesOut	1	Discount Rate	15.00
Long Term Debt	0.00	Long Term Growth Rate	5.00
		Long Term Discount Rate	15.00
DCF-IV	**25.98**		

Using 1.46 TTM EPS as a proxy for cash flow, the IV is calculated between **$25.98 and $42.05.**

II. Comparison based tool: Peer Price to Earnings Ratio (P/E Ratio)

To work out the relative value of BWLD, I am adapting the valuation by Cowen & Company and comparing BWLD against the average PE of high growth peers and against the average PE of low growth peers.

I am using historical trailing twelve months P/E because this is factual, though not forward looking.

High Growth Peers	Price	P/E TTM
BJRI	14.34	35.10
CMG	79.19	30.20
PEET	26.09	29.60
PNRA	53.24	22.40
Average		**29.33**

No Growth Peers	Price	P/E TTM
CAKE	17.06	21.90
PFCB	31.94	20.1
TXRH	11.63	21.30
DRI	36.17	14.50
EAT (average)	17.90	19.80
Average		**19.52**

** I substituted the TTM P/E of Brinker’s (Chili’s Restaurant, Ticker:EAT) with its 10 year average because it had a PE of 51+, which is a not consistent.

	Current Price	P/E TTM
BWLD	35.50	24.30

By comparing BWLD against its high growth peers and its low growth peers, we work out a multiple of 29.33x and 19.52x. It translates the EPS TTM of 1.46 to a new BWLD price range of **$28.50 and $42.82** per share.

III. 5 Year Thumbnail Valuation for Growth Stock (TMF method)

Assumption: 5 years earnings growth rate of 20% a year, this is keeping inline with management's long term EPS growth goal.

Earnings (trailing twelve months) of 26m x (1.20)^5 = 64.7m earnings in 5 years.

P/E multiple of Growth Rate x 1.3 = 20*1.3 = 26 times

Market cap in 5 years = 26 x 64.7m= 1682.2m

Divided by Shares outstanding of 18m = $93.5 per share

Target share price in 5 years is **$93.5** assuming 20% EPS growth a year.

From the current share price of $35.5, this works out roughly 21% share price growth a year. If I were to model a Earnings growth of 15%, the per year share price appreciation of only 9.8%

EPS Growth	Share Price in 5 yrs	Share price appreciation from last current price
20%	$93.5	21% a year
15%	$56.7	9.8% a year

IV Summary of BWLD Valuation

From valuation calculated in (I) & (II), I put BWLD's intrinsic value between $27 and $42. Using a margin of safety of 35%, this puts the buy price between $17.5 and $27.3. Interestingly, Morningstar puts BWLD a fair value of $27 and a buy below price of $13.50.

3. How attractive is the current price for this company, and what should I pay for it?

The 52 week price range is quite extreme; it reached a euphoric $ 44.98 in Sep 2008 and a low of 14.50 in Nov 2008 where investors priced it as a stock with a perpetual growth of only 5%. It recently touched a shade below $43 at the end of April. The current price is $35.50.

The reason for the extreme price appreciation in the last months (almost 100%) is because (a) BWLD managed to beat analyst expectations (b) reaffirmed its 2009 EPS projection (and long term EPS growth of 20%).

By using forward estimates, analysts find that BWLD is trading at a cheap multiple, of 7.7x times EV/2009 EBITDA estimates, which is only slightly higher than the multiple given to slow growth companies and not the 9.3x EBITDA multiple given to High Growth restaurants.

Figure 1. Valuation vs. High-Growth Peers

Company	Price 4/28/09	EV	2009 EBITDA	2009 EV/EBITDA
BJRI	$ 17.11	$429	$49	8.7X
CMG	$ 84.17	$2,573	$239	10.8X
PEET	$ 24.52	$308	$36	8.6X
PNRA	$ 62.93	$1,861	$202	9.2X
Average				9.3X
BWLD*	$ 40.00	$671	$87	7.7X

*Estimates BWLD's 4/29/09 open

Source: Cowen and Company, Company Reports

Figure 2. Valuation vs. No-Growth Casual Dining

Company	Price 4/28/09	EV	C2009 EBITDA	C2009 EV/EBITDA
CAKE	$ 17.04	$1,206	$163	7.4X
PFCB	$ 31.87	$816	$140	5.8X
TXRH	$ 11.24	$927	$112	8.3X
DRI	$ 38.11	$7,130	$940	7.6X
EAT	$ 17.68	$2,575	$413	6.2X
Average				7.1X
BWLD*	$ 40.00	$671	$87	7.7X

*Estimates BWLD's 4/29/09 open

Source: Cowen and Company, Company Reports

Because of the recent analyst upgrades at the positive earnings surprise, BWLD shares are priced for perfection. There is a 30% short position on BWLD. Any negative outlook or challenges will cause the share price to swoon.

Owning BWLD shares is making a bet that the management team will grow the company to the stated 1000 outlets goal and possibly make an expansion into the overseas market. I am confident that this is achievable. However, rather than buy into a richly valued company, past experience with BWLD stock has shown that we are almost always given a chance to buy at the right price if we are patient.

4. How realistic is the most effective catalyst?

Because of the high expectations on BWLD, the following are the possible catalysts to unlocking the price:

Positive Catalysts:

- Company continues to meet and beat analyst estimates through the winning Fast Casual concept.

- The economy picks up and consumer trend continue to favor eating away from home.

- BWLD is successful in growing the lunch segment past 21% as well as expand the growing late night segment.

- BWLD expands overseas, eg. in Asia where crispy chicken have shown to be successful. (eg. KFC is more popular than McDonalds in China)

Negative Catalysts

- The most serious is not being able to meet analyst expectations. For example, BWLD is heavily concentrated in Michigan, Indiana, Illinois, Wisconsin, Minnesota and Texas, these states are very affected by possible auto industry fallout, and restaurant units will feel the brunt of a sales slowdown if substantial auto manufacturing jobs are lost.

- Other exogenous threats such as Avian Flu or diminished interests in sports will affect likely affect BWLD. (See TOWS analysis)

Appendix I : Porter's Five Forces

Porter's Five Forces

Porter's Five Forces				**Analysis**
I. Threat of New Entrants	**Yes**	**NA**	**No**	
1. Do large firms have a cost or performance advantage in your segment of the industry?	●			Established firms have favorable contracts with long term suppliers and better brand recognition.
2. Are there any proprietary product differences in your industry?			●	Most food can be replicated, and much of the food items and menus are similar.
3. Are there any established brand identities in your industry?	●			Branding makes a bigger difference.
4. Do your customers incur any significant costs in switching suppliers?			●	Customer may favor one restaurant over the other but they typically have more than one restaurant that they visit.
5. Is a lot of capital needed to enter your industry?			●	While set up costs of a restaurant is expensive, it is not prohibitive. Bank borrowing / pooling of funds/ or franchising is enough to set up a restaurant.
6. Is serviceable used equipment expensive?			●	Much of the equipment is readily available and reusable.
7. Does the newcomer to your industry face difficulty in accessing distribution channels?			●	No. Distribution channels are limited location space, usually adjacent to a mall or other place of entertainment.
8. Does experience help you to continuously lower costs?	●			Management Experience and a good data warehouse (IT) will help to analyze and reduce costs.
9. Does the newcomer have any problems in obtaining the necessary skilled people, materials or suppliers?			●	Skills such as server / cashiers / cooks are easy to hire. Ditto to suppliers and materials.
10. Does your product or device have any proprietary features which give you lower costs?		●		Having a fixed menu helps to lower costs across all restaurant outlets. But typically, there isn't a proprietary feature that lowers the costs.
11. Are there any licenses, insurance or qualifications which are difficult to obtain?			●	It is not difficult to attain a license.
12. Can the newcomer expect strong retaliation on entering the market?	●			Rivalry among new entrants is strong.
II. Bargaining Power of Buyers	**Yes**	**NA**	**No**	
1. Is there a large number of buyers relative to the number of firms in the business?	●			Yes. Demographic shift towards eating out is increasing.
2. Do you have a relatively large number of customers each with relatively small purchases?	●			Size per cheque is still small relative to company sales.

3. Does the customer face any significant costs in switching suppliers?			•	None.
4. Does the buyer need a lot of important information?			•	None.
5. Is the buyer aware of the need for additional information?			•	None.
6. Is there anything which prevents your customer from taking our function in-house?			•	None. Customers can “integrate vertically” by cooking at home.
7. You customers are not highly sensitive to price?			•	Customers are sensitive to high prices in food.
8. Your product is unique to some degree or has accepted branding?	•			Yes. Branding is important.
9. Your customers' businesses are profitable?		•		NA. But this is a function of discretionary incoming
10. You provide incentives to the decision makers?	•			Promotions, coupons and special days are incentives.
III. Threat of Substitutes	**Yes**	•	**No**	
1. Substitutes have performance limitations which do not completely offset their lowest price or their performance advantage is not justified by their higher price.	•			This is not a strong Yes. Cooking and Eating at home is a substitute but the time taken plus the customer experience may be very different from dining out.
2. The customer will incur costs in switching to a substitute.			•	None. Usually cost of materials, labor and time.
3. Your customer has no real substitute.			•	Eating at home is a substitute.
4. Your customer is not likely to substitute.			•	In the near term, recessionary fears will make people eat more at home, similar to 2001 data.
IV. Bargaining Power of Suppliers	**Yes**	**NA**	**No**	
1. My inputs (materials, labor, supplies, services, etc.) are standard rather than unique or differentiated.	•			Yes. The is a “cookie-cutter” approach
2. I can switch between suppliers quickly and cheaply.			•	It isn’t easy to switch without incurring additional costs and it is unlikely to receive favorable pricing.
3. My suppliers would find it difficult to enter my business or my customers would find it difficult to perform my function in-house.			•	No. Some of the suppliers also sell substitutes products to Grocery and Supermarket which compete with restaurants.
4. I can substitute inputs readily.			•	Restaurant is a labor-intensive business; it is not easy to replace inputs with substitutes without rethinking the business model. For example, to replace human servers with technology is to switch business model from a fine dining to a QSR (quick service restaurant).

5. I have many potential suppliers.			●	No. The market is dominated by a few large monopolistic players (SYSCO and Performance Food Meadowbrook Meats company) and many smaller niche companies like Smithfields Foods (for Pork and Beef products).
6. My business is important to my suppliers.			●	No. There are many restaurant establishments for my suppliers to choose from.
7. My cost of purchases has no significant influence on my overall costs.			●	Costs of Raw materials contributes to 25 ~ 35% of overall costs.
V. Determinants of Rivalry Among Existing Competitors	**Yes**	**NA**	**No**	
1. The industry is growing rapidly.			●	The industry is growing with the 1) growth of the population 2) growth of the economy 3) rise in demographics of eating out. Annual growth in the past 5 years is 4~ 5% (according to Freedonia Research).
2. The industry is not cyclical with intermittent over-capacity.			●	The industry is cyclical and a growing economy buoys the industry.
3. The fixed costs of the business are a relatively low portion of total costs.			●	Fixed costs are significant. For example, a 5000 square feet restaurant requires incurs an initial capex cost of 1.5m and about 200k of remodeling cost every 2 year.
4. There are significant product differences and brand identities between the competitors.	●			Yes.
5. The competitors are diversified rather than specified.	●			Competitors are more diversified than specific, although the food or concept isn't unique.
6. It would not be hard to get out of this business because there are no specialized skills and facilities or long-term contract commitments, etc.	●			Easy to resell the equipment or to close one unit and open in another location.
7. My customers would incur significant costs in switching to a competitor.			●	No
8. My product is complex and requires a detailed understanding on the part of my customer.			●	No.
9. My competitors are all of approximately the same size as I am.			●	No. Competitors vary in size and national chains are the largest.

"Threat of New Entrants" Analysis

There is low barrier of entry to the restaurant business, an ambitious entrepreneur can open as a sole proprietor single restaurant, or choose a franchise model to keep the costs low while pursuing a unit restaurant growth strategy. Equipment providers, such as Middleby are also standardizing the foodservice equipment used in the kitchen, and these can be reused across different restaurants, lowering the startup costs.

The threat is mitigated by established companies have strong brand names, economies of scale from suppliers with long term contracts, and benefits from continuous lowering of costs through management experience.

"Bargaining Power of Buyers" Analysis

Bargaining power of buyers exists because there are no switching costs, consumers are free to choose, within a certain price band, and a certain taste preference, whichever restaurant that appeals to them. Branding thus becomes very important in ensuring loyalty and repeat business.

The demographic trend is towards eating away from home, partly due to an increase in discretionary income (especially by the Baby Boomers) and partly due to a more "convenience"-driven lifestyle; this is offset by a high price elasticity of demand. If commodity prices remain high, and a recession prolongs, buyers will be more inclined to cook at home. This is because foodservice is not seen as strictly essential to consumers.

"Threat of Substitutes" Analysis

The biggest threat to the restaurant industry is that buyers may "backward integrate" by buying raw materials cheaply and cooking for themselves. This is made easier because the main switching cost is the opportunity cost of time spent in the kitchen; this is viable since the costing at home is cheaper than dining out.

The other substitute threat is the "entertainment" value of dining with friends and family; in this case, other places of entertainment would be the substitute threat. For example, a group of friends may choose to congregate at a cafe or choose to go for a movie.

"Bargaining Power of Suppliers" Analysis

This industry is labor intensive, and with minimum wage regulations, restaurants need to keep the other factor costs low, and this raises the importance of suppliers. However, food distribution is dominated by a few large players such as Syco, Performance Food group and Meadowbrook Meats (collectively controlling about 30% of the food distribution market, according to Morningstar). Due to the large number of companies which they serve, eg. Sysco has 400,000 customers, they are less inclined to keep prices down. The rest of the foodservice distribution business is owned by smaller niche companies distributing specific food types, eg. Smithfield delivers mainly pork to medium and higher-priced segments. Switching suppliers would incur direct costs such as renegotiating favorable long term contracts as well as indirect costs such as ensuring the food receives priority and is adequately fresh.

Most lower to moderate segment of the restaurant chain would find it difficult to backward integrate by buying directly from the farmer's market. It would be more feasible to buy from a wholesale grocer like Sysco which has a SKU of 300,000 items across all states in the US.

"Rivalry among Existing Competitors" Analysis

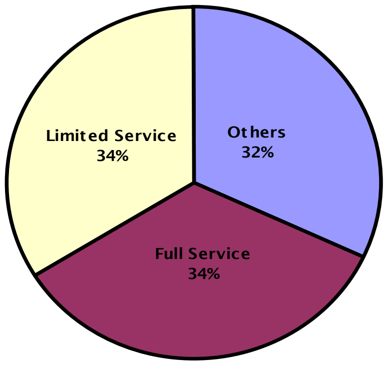
The rivalry among existing competitors is strong overall. While the competitors tend to be more diversified than specific, there are many companies with similar structures offering similar products and consumers do not incur cost switching from one restaurant to another.

The economy has been doing well in the past few years, this eases the rivalry since companies do not need to encroach customer from other competitors, and expansion is relatively easy. However, since this is a cyclical industry on the downside, the opposite is true, competition will greatly increase and many competitors will exit with relative ease (equipment can be sold off, and staff can be laid off with out costly redundancy expense).

Larger chains will have lower cost structures and are able to sustain a price war (price discounts, coupons, promotion day etc), while smaller restaurants have to rely on niche service, quality and promotions to maintain the wallet-share of it customers.

Appendix II: The Restaurant Industry

The US restaurant industry encompasses full service restaurants, limited service and other foodservice venues, in 2007, it generated $556bn and each segment is almost a third.



(Source: The Freedonia Group)

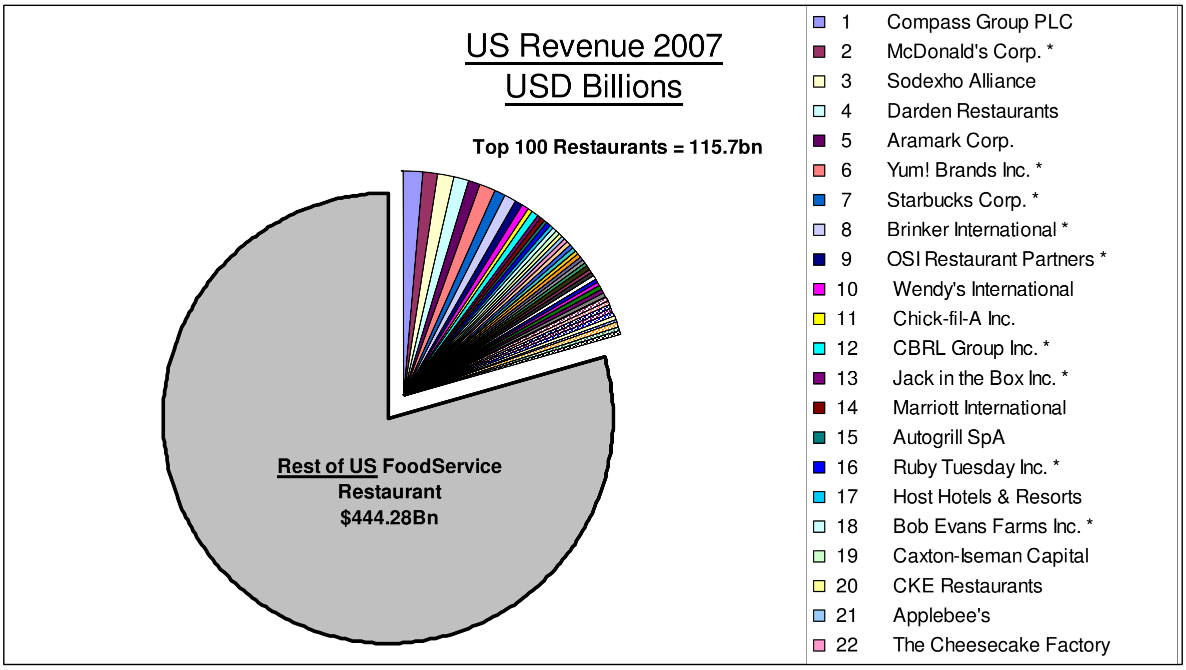
The Full Service segment is traditionally known as “sit-down” restaurant; food is ordered and served at the table by a waiter/server. In 2007, there were 212,000 casual, family and fine dining restaurants. In recent years, casual dining has been the growth driver in this segment, examples include Applebee’s Chili’s, Outback Steakhouse etc.

Limited service is mainly fast foods, coffee shops, and is limited by the type of service offered, customers go to the counter, order and pay for the food. However, there is a sub-segment that is experiencing high growth, called the Fast Casual restaurants, found in the Limited Service segment. Similar to fast food restaurants, customers at Fast Casuals like Panera Bread or Chipotle Mexican Grill order at the cash register, select the items and pay before the meat is eaten; however the quality of food is better and similar to casual dining and a different décor than traditional QSRs (quick service restaurant ala Fast Food). The check average is also higher than a QSR. (Source: Wikipedia.com). Traditional Fast Food restaurants are also experiencing growth from non-traditional food items like premium coffee, cookies and gourmet desserts.

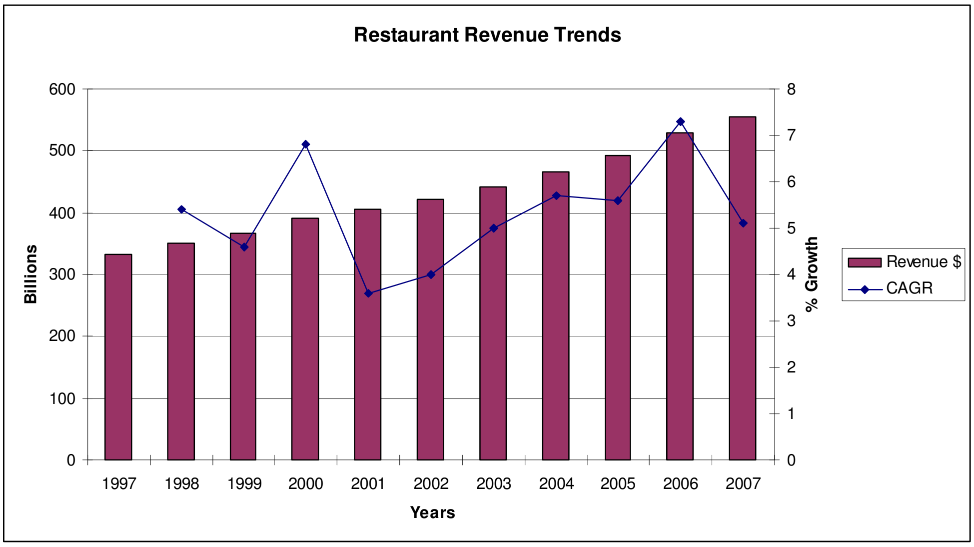
The last restaurant segment includes revenue from foodservice generated at institutional establishment, eg. hospitals, cafeteria at schools, workplace, and retail stores as well as hotels.

Industry Competitive Structures (ICS)
This industry is highly fragmented. The top 100 largest restaurant chains by revenue represent only 20.53% of the 560bn US Restaurant business. This is represented by the pie chart below, the source of the top 100 restaurants is provided by NRN Research.

The number is likely to be higher because the reported numbers includes only company owned stores and fees collected by the franchise; the restaurant revenues by the franchise stores are not included. The bulk of the industry is made up of smaller chains, single restaurants and cafes.



The restaurant business is a slow growth business, the chart below shows the restaurant growing on average at 5.7% from 2002 to 2007, this tracks closely with the GDP growth during the same period.



(Source: Datamonitor)

	% Annual Growth				
	2002	**2007**	**2012 est**	**2002 t0 2007**	**2207 to 2012 (est)**
GDP	10470	13808	17550	5.70%	4.90%
Population	287.9	301.6	316.6	9%	1.00%
Disposable income	7830	10171	12980	5.40%	5.00%
Consumer Food Exp.	879	1140	1450	5.3	4.90%
% Away-from-home	47.90%	48.80%	49.70%	0.4%	0.4%

(Source: Datamonitor & Freedonia Group Inc.)

Demographic shifts have resulted in consumers spending 48.8% of their consumer food expenditure on eating out:

- Focus on convenience. A focus on convenience has substituted time spent on cooking to eating out. People increasingly find the opportunity cost of making a meal at home costly compared to eating out. Restaurants are responding to this trend by having take-out counters in casual restaurants as well as special convenient parking lots for take-aways.

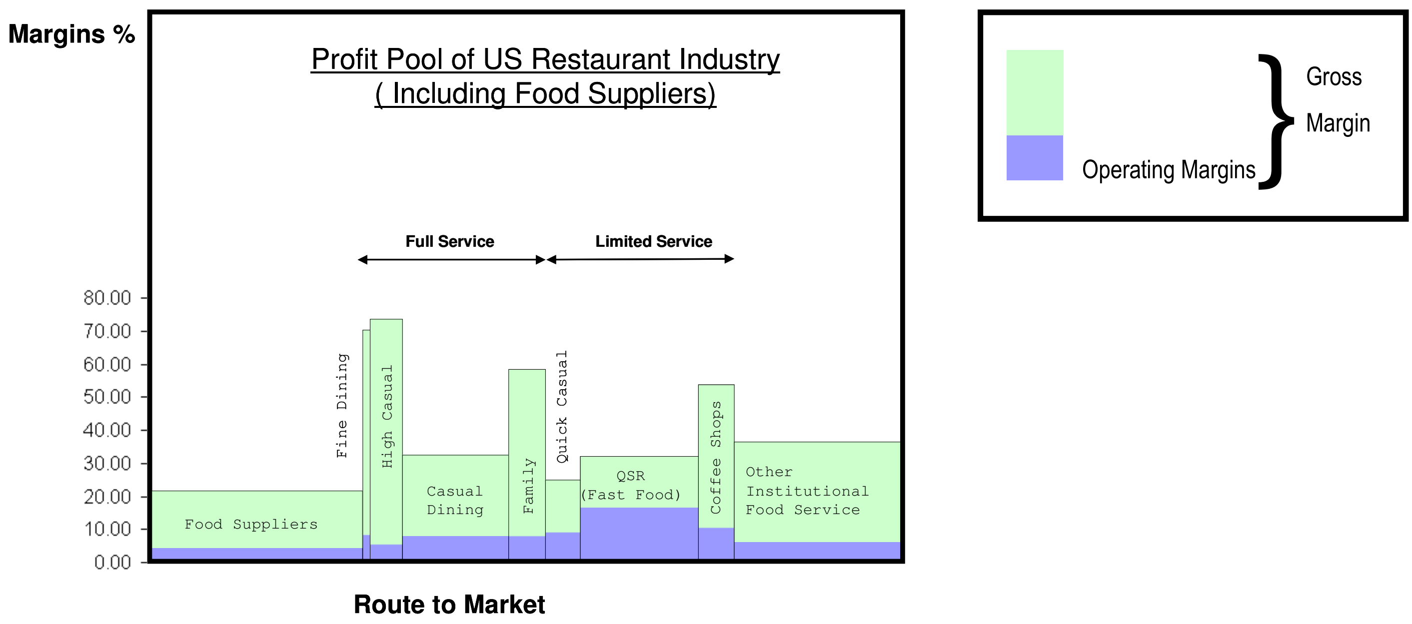
- Increasing disposable income has resulted in eating out an affordable activity. This is especially through of Baby Boomers (the generation born after WWII) where they are at the peak of their earning capability.

- Eating out as a convenient third place. Eating out is increasingly becoming a third place after the home and workplace. Eating out is no longer frequented as a special occasion but people are comfortable going out to a restaurant to catch up with friends.

Analysis of Industry Financial

No	**Category**	**Industry Snapshot**	**Source**
1	*Revenue Growth*	5.1%	Freedonia, inc.5yrs data
2	*Establishment unit Growth*	1.5%	Freedonia, inc. 5yrs data
3	*Gross Margin%*	42.4%	Morningstar
4	*Operating Margin%*	9.6%	Morningstar
5	*ROE%*	18.8%	Morningstar
6	*Debt / Equity*	85.2%	Reuters
7	*Quick Ratio*	0.9	Reuters

The industry grew at 5.1% year-on-year for 2007. This tracks quite closely with the GDP growth plus 1.5% due to inflation. The slower revenue growth in 2007 reflects the slowing of the economy in Q4 2007 as compared to the 5.7% annual growth in the previous five years. The number of establishments grew at a slower 1.5% to a total of 469,000 restaurants, as compared to the previous five years which grew at 2.17% annually.



1. The highest gross margin can be found in Fine Dining and High Casual Dining. This is because of the high check value compared to the raw material costs. Many fine-dining establishments buy from farms directly because of the quality or specialty meats required, and this bypasses the middlemen. However, high check prices does not translate to highest operating margins, in fact, the high-end casual dining segment has one of the lowest operating margins. This is due to high maintenance of the restaurants and higher overheads needed to run the restaurants.

2. A new category that is rapidly growing is the Fast Casual segment, this is unique in that it serves higher quality food with menu found similar to Casual Dining, but it has limited table service, and it usually has an active take-out counter. The average check size is between $8 to $15, which is higher than a typical fast food (http://en.wikipedia.org/wiki/Fast_casual_restaurant) but cheaper than casual dining ($12 ~ $15 for lunch, $20 for dinner). While the gross margin is lower than casual dining, the operating margin is higher, this is because of the lack of servers, greeters and other expensive labor found in Full service restaurants. According to Nollenberger Capital Partner Research report, 23rd August 2007, the Fast casual dining concept is eroding the traditional casual dining segment.

3. Despite being the oldest convenience dining-out concept, QSR (Quick service restaurants or Fast-Food) has the highest operating margin, the reasons for this are a) Being the earliest means that the operations are highly optimized and standardized b) Inflationary cost and commodity cost can be passed onto the customers more easily than other higher-end restaurants and lastly c) the concept itself has little labor cost unlike other restaurant which is labor intensive.

4. The coffee café business is an attractive segment. The gross margins are the fourth highest in the entire restaurant business but the operating margins are the second highest. Starbucks has created a very strong branding in this business and it has propagated over to Tim Horton and Peet's coffee. (Found in the Appendix)

5. The food distribution / supplier business is a difficult business, with low margins generally. This segment favors scale, the largest company Sysco has the best margins which is still quite low at 4.7% The no.2 and no.3 companies have operating margins under 2%.

Conclusion on Profit pool analysis: The data seem to suggest that profits can be found in the less crowded Fast Casual segment, and also in the Coffee segment, lastly, QSR or Fast Foods, should be explored further since the profits are quite consistent across this segment.