

Additional Case 2



Panera Bread Company

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As Panera Bread Company headed into 2007, it was continuing to expand its market presence swiftly. The company's strategic intent was to make great bread broadly available to consumers across the United States. It had opened 155 new company-owned and franchised bakery-café in 2006, bringing its total to 1,027 units in 36 states. Plans were in place to open another 170 to 180 café locations in 2007 and to have nearly 2,000 Panera Bread bakery-café open by the end of 2010. Management was confident that Panera Bread's attractive menu and the dining ambience of its bakery-café provided significant growth opportunity, despite the fiercely competitive nature of the restaurant industry.

Already Panera Bread was widely recognized as the nationwide leader in the specialty bread segment. In 2003, Panera Bread scored the highest level of customer loyalty among quick-casual restaurants, according to a study conducted by TNS Intersearch.¹ J. D. Power and Associates' 2004 restaurant satisfaction study of 55,000 customers ranked Panera Bread highest among quick-service restaurants in the Midwest and Northeast regions of the United States in all categories, which included environment, meal, service, and cost. In 2005, for the fourth consecutive year, Panera Bread was rated among the best of 121 competitors in the Sandleman & Associates national customer satisfaction survey of more than 62,000 consumers. Panera Bread had also won "best of" awards in nearly every market across 36 states.

COMPANY BACKGROUND

In 1981, Louis Kane and Ron Shaich founded a bakery-café enterprise named Au Bon Pain Company Inc. Units were opened in malls, shopping centers, and airports along the East Coast of the United States and internationally throughout the 1980s and 1990s; the company prospered and became the dominant operator within the bakery-café category. In 1993, Au Bon Pain Company purchased Saint Louis Bread Company, a chain of 20 bakery-café located in the St. Louis, Missouri, area. Ron Shaich and a team of Au Bon Pain managers then spent considerable time in 1994 and 1995 traveling the country and studying the market for fast-food and quick-service meals. They concluded that many patrons of fast-food chains like McDonald's, Wendy's, Burger King, Subway, Taco Bell, Pizza Hut, and KFC could be attracted to a higher-quality, quick-dining experience. Top management at Au Bon Pain then instituted a comprehensive overhaul of the newly-acquired Saint Louis Bread locations, altering the menu and the dining atmosphere. The vision was to create a specialty café anchored by an authentic, fresh-dough artisan bakery and upscale quick-service menu selections. Between 1993 and 1997, average unit volumes at the revamped Saint Louis Bread units increased by 75 percent, and over 100 additional Saint Louis Bread units were opened. In 1997, the Saint Louis Bread bakery-café were renamed Panera Bread in all markets outside St. Louis.

By 1998, it was clear that the reconceived Panera Bread units had connected with consumers. Au Bon Pain management concluded the Panera Bread format

had broad market appeal and could be rolled out nationwide. Ron Shaich believed that Panera Bread had the potential to become one of the leading fast-casual restaurant chains in the nation. Shaich also believed that growing Panera Bread into a national chain required significantly more management attention and financial resources than the company could marshal if it continued to pursue expansion of both the Au Bon Pain and Panera Bread chains. He convinced Au Bon Pain's board of directors that the best course of action was for the company to go exclusively with the Panera Bread concept and divest the Au Bon Pain cafés. In August 1998, the company announced the sale of its Au Bon Pain bakery-café division for \$73 million in cash to ABP Corporation; the transaction

was completed in May 1999. With the sale of the Au Bon Pain division, the company changed its name to Panera Bread Company. The restructured company had 180 Saint Louis Bread and Panera Bread bakery-café and a debt-free balance sheet.

Between January 1999 and December 2006, close to 850 additional Panera Bread bakery-café were opened, some company-owned and some franchised. Panera Bread reported sales of \$829.0 million and net income of \$58.8 million in 2006. Sales at franchise-operated Panera Bread bakery-café totaled \$1.2 billion in 2006. A summary of Panera Bread's recent financial performance is shown in Exhibit 1.

Exhibit 1 Selected Consolidated Financial Data for Panera Bread, 2002–2006
(\$ in millions, except for per share amounts)

| | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|-----------|-----------|------------|-----------|-----------|
| Income Statement Data | | | | | |
| Revenues: | | | | | |
| Bakery-café sales | \$666,141 | \$499,422 | \$362,121 | \$265,933 | \$212,645 |
| Franchise royalties and fees | 61,531 | 54,309 | 44,449 | 36,245 | 27,892 |
| Fresh dough sales to franchisees | 101,299 | 86,544 | 72,569 | 61,524 | 41,688 |
| Total revenues | 828,971 | 640,275 | 479,139 | 363,702 | 282,225 |
| Bakery café expenses: | | | | | |
| Food and paper products | 197,182 | 142,675 | 101,832 | 73,885 | 63,370 |
| Labor | 204,956 | 151,524 | 110,790 | 81,152 | 63,172 |
| Occupancy | 48,602 | 37,389 | 26,730 | 18,981 | 15,408 |
| Other operating expenses | 92,176 | 70,003 | 51,044 | 36,804 | 27,971 |
| Total bakery café expenses | 542,916 | 401,591 | 290,396 | 210,822 | 169,921 |
| Fresh dough costs of sales to franchisees | 85,618 | 75,036 | 65,627 | 54,967 | 38,432 |
| Depreciation and amortization | 44,166 | 33,011 | 25,298 | 18,304 | 13,794 |
| General and administrative expenses | 59,306 | 46,301 | 33,338 | 28,140 | 24,986 |
| Pre-opening expenses | 6,173 | 3,241 | 2,642 | 1,531 | 1,051 |
| Total costs and expenses | 738,179 | 559,180 | 417,301 | 313,764 | 248,184 |
| Operating profit | 90,792 | 81,095 | 61,838 | 49,938 | 34,041 |
| Interest expense | 92 | 50 | 18 | 48 | 32 |
| Other (income) expense, net | (1,976) | (1,133) | 1,065 | 1,592 | 467 |
| Provision for income taxes | 33,827 | 29,995 | 22,175 | 17,629 | 12,242 |
| Net income | \$ 58,849 | \$ 52,183 | \$ 38,430* | \$ 30,669 | \$ 21,300 |
| Earnings per share | | | | | |
| Basic | \$1.88 | \$1.69 | \$1.28 | \$1.02 | \$0.74 |
| Diluted | 1.84 | 1.65 | 1.25 | 1.00 | 0.71 |

(Continued)

Exhibit 1 Continued

| | 2006 | 2005 | 2004 | 2003 | 2002 |
|--|-----------|------------|-----------|-----------|-----------|
| Weighted average shares outstanding | | | | | |
| Basic | 31,313 | 30,871 | 30,154 | 29,733 | 28,923 |
| Diluted | 32,044 | 31,651 | 30,768 | 30,423 | 29,891 |
| Balance Sheet Data | | | | | |
| Cash and cash equivalents | \$ 52,097 | \$ 24,451 | \$ 29,639 | \$ 42,402 | \$ 29,924 |
| Investments in government securities | 20,025 | 46,308 | 28,415 | 9,019 | 9,149 |
| Current assets | 127,618 | 102,774 | 58,220 | 70,871 | 59,262 |
| Total assets | 542,609 | 437,667 | 324,672 | 256,835 | 195,431 |
| Current liabilities | 109,610 | 86,865 | 55,705 | 44,792 | 32,325 |
| Total liabilities | 144,943 | 120,689 | 83,309 | 46,235 | 32,587 |
| Stockholders' equity | 397,666 | 316,978 | 241,363 | 193,805 | 151,503 |
| Cash Flow Data | | | | | |
| Net cash provided by operating activities | \$104,895 | \$ 110,628 | \$ 84,284 | \$ 73,102 | \$ 46,323 |
| Net cash used in investing activities | (90,917) | (129,640) | (102,291) | (66,856) | (40,115) |
| Net cash provided by financing activities | 13,668 | 13,824 | 5,244 | 6,232 | 5,664 |
| Net (decrease) increase in cash and cash equivalents | 27,646 | (5,188) | (12,763) | 12,478 | 11,872 |

* After adjustment of \$239,000 for cumulative effect of accounting change.

Sources: 2006 10-K report, pp. 36–38, 2005 10-K report, pp. 16–17; 2003 10-K report, pp. 29–31; and company press release, February 8, 2007.

THE PANERA BREAD CONCEPT AND STRATEGY

The driving concept behind Panera Bread was to provide a premium specialty bakery and café experience to urban workers and suburban dwellers. Its artisan sourdough breads made with a craftsman's attention to quality and detail and its award-winning bakery expertise formed the core of the menu offerings. Panera Bread specialized in fresh baked goods, made-to-order sandwiches on freshly baked breads, soups, salads, custom roasted coffees, and other café beverages. Panera's target market was urban workers and suburban dwellers looking for a quick-service meal and a more aesthetically pleasing dining experience than that offered by traditional fast food restaurants.

In his letter to shareholders in the company's 2005 annual report, Panera chairman and CEO Ron Shaich said:

We think our continued commitment to providing crave-able food that people trust, served in a warm, community gathering place by associates who make our guests feel comfortable, really matters. When this is rooted in our commitment to the traditions of handcrafted, artisan bread, something special is created. As we say here at Panera, it's our Product, Environment, and Great Service (PEGS) that we count on to deliver our success—year in and year out.

Panera Bread's distinctive menu, signature café design, inviting ambience, operating systems, and unit location strategy allowed it to compete successfully in five submarkets of the food-away-from-home industry: breakfast, lunch, daytime "chill out" (the time between breakfast and lunch and between lunch and dinner when customers

Exhibit 2 Selected Operating Statistics, Panera Bread Company, 2000–2006

| | 2006 | 2005 | 2004 | 2003 | 2002 | 2001 | 2000 |
|--|------------|------------|------------|------------|------------|------------|------------|
| Revenues at company-operated stores (in millions) | \$ 666.1 | \$ 499.4 | \$ 362.1 | \$ 265.9 | \$ 212.6 | \$ 157.7 | \$ 125.5 |
| Revenues at franchised stores (in millions) | \$1,245.5 | \$1,097.2 | \$ 879.1 | \$ 711.0 | \$ 542.6 | \$ 371.7 | \$ 199.4 |
| Systemwide store revenues (in millions) | \$1,911.6 | \$1,596.6 | \$1,241.2 | \$ 976.9 | \$ 755.2 | \$ 529.4 | \$ 324.9 |
| Average annualized revenues per company-operated bakery-café (in millions) | \$ 1.967 | \$ 1.942 | \$ 1.852 | \$ 1.830 | \$ 1.764 | \$ 1.636 | \$ 1.473 |
| Average annualized revenues per franchised bakery-café (in millions) | \$ 2.074 | \$ 2.016 | \$ 1.881 | \$ 1.860 | \$ 1.872 | \$ 1.800 | \$ 1.707 |
| Average weekly sales, company-owned cafés | \$ 37,833 | \$ 37,348 | \$ 35,620 | \$35,198 | \$33,924 | \$31,460 | \$28,325 |
| Average weekly sales, franchised cafés | \$ 39,894 | \$ 38,777 | \$ 36,171 | \$35,777 | \$35,997 | \$34,607 | \$32,832 |
| Comparable bakery-café sales percentage increases* | | | | | | | |
| Company-owned | 3.9% | 7.4% | 2.9% | 1.7% | 4.1% | 5.8% | 8.1% |
| Franchised | 4.1% | 8.0% | 2.6% | (0.4)% | 6.1% | 5.8% | 10.3% |
| Systemwide | 4.1% | 7.8% | 2.7% | 0.2% | 5.5% | 5.8% | 9.1% |
| Company-owned bakery-café open at year-end | 391 | 311 | 226 | 173 | 132 | 110 | 90 |
| Franchised bakery-café open at year-end | <u>636</u> | <u>566</u> | <u>515</u> | <u>429</u> | <u>346</u> | <u>259</u> | <u>172</u> |
| Total bakery-café open | 1,027 | 877 | 741 | 602 | 478 | 369 | 262 |

* The percentages for comparable store sales are based on annual changes at stores open at least 18 months.

Sources: Company 10-K reports 2000, 2001, 2003, 2005, and 2006; company press releases, January 4, 2007, and February 8, 2007.

visited its bakery-café to take a break from their daily activities), light evening fare for eat-in or take-out, and take-home bread. In 2006, Panera began enhancing its menu in ways that would attract more diners during the evening meal hours. Management's long-term objective and strategic intent was to make Panera Bread a nationally recognized brand name and to be the dominant restaurant operator in the specialty bakery-café segment. According to Scott Davis, Panera's senior vice president and chief concept officer, the company was trying to succeed by "being better than the guys across the street" and making the experience of dining at Panera so attractive that customers would be willing to pass by the outlets of other

fast-casual restaurant competitors to dine at a nearby Panera Bread bakery-café.² Davis maintained that the question about Panera Bread's future was not *if* it would be successful but *by how much*.

Management believed that its concept afforded growth potential in suburban markets sufficient to expand the number of Panera bread locations by 17 percent annually through 2010 (see Exhibits 3 and 4) and to achieve earnings per share growth of 25 percent annually. Panera Bread's growth strategy was to capitalize on Panera's market potential by opening both company-owned and franchised Panera Bread locations as fast as was prudent. So far, franchising had been a key component of the company's efforts to broaden its market penetration. Panera Bread

Exhibit 3 Areas of High and Low Market Penetration of Panera Bread Bakery-Cafés, 2006

| High Penetration Markets | | | Low Penetration Markets | | |
|-----------------------------------|------------------------------|----------------------------|-------------------------|------------------------------|----------------------------|
| Area | Number of Panera Bread Units | Population per Bakery-Café | Area | Number of Panera Bread Units | Population per Bakery-Café |
| St. Louis | 40 | 67,000 | Los Angeles | 17 | 1,183,000 |
| Columbus, OH | 19 | 83,000 | Miami | 2 | 1,126,000 |
| Jacksonville | 12 | 98,000 | Northern California | 10 | 1,110,000 |
| Omaha | 12 | 101,000 | Seattle | 5 | 860,000 |
| Cincinnati | 26 | 108,000 | Dallas/Fort Worth | 10 | 590,000 |
| Pittsburgh | 25 | 142,000 | Houston | 12 | 335,000 |
| Washington D.C./Northern Virginia | 26 | 152,000 | Philadelphia | 25 | 278,000 |
| Untapped Markets | | | | | |
| New York City | | Phoenix | | Austin | |
| Salt Lake City | | Tucson | | San Antonio | |
| Memphis | | District of Columbia | | Green Bay/Appleton | |
| New Orleans | | Spokane | | Shreveport | |
| Atlantic City | | Baton Rouge | | Toronto | |
| Albuquerque | | Little Rock | | Vancouver | |

Source: Panera Bread management presentation to securities analysts, May 5, 2006

had organized its business around company-owned bakery-café operations, the franchise operations, and fresh dough operations; the fresh bread unit supplied dough to all Panera Bread stores, both company-owned and franchised.

Exhibit 4 Comparative U.S. Market Penetration of Selected Restaurant Chains, 2006

| Restaurant Chain | Number of Locations | Population per Location |
|------------------|---------------------|-------------------------|
| Subway | 19,965 | 15,000 |
| McDonald's | 13,727 | 22,000 |
| Starbucks Coffee | 7,700 | 39,000 |
| Applebee's | 1,800 | 166,000 |
| Panera Bread | 910 | 330,000 |

Note: Management believed that a 17 percent annual rate of expansion of Panera Bread locations through 2010 would result in 1 café per 160,000 people.

Source: Panera Bread management presentation to securities analysts, May 5, 2006.

PANERA BREAD'S PRODUCT OFFERINGS AND MENU

Panera Bread's signature product was artisan bread made from four ingredients—water, natural yeast, flour, and salt; no preservatives or chemicals were used. Carefully trained bakers shaped every step of the process, from mixing the ingredients, to kneading the dough, to placing the loaves on hot stone slabs to bake in a traditional European-style stone deck bakery oven. Exhibit 5 shows Panera's lineup of breads.

The Panera Bread menu was designed to provide target customers with products built on the company's bakery expertise, particularly its 20-plus varieties of bread baked fresh throughout the day at each café location. The key menu groups were fresh baked goods, made-to-order sandwiches and salads, soups, light entrées, and café beverages. Exhibit 6 shows a sampling of the items on a typical Panera Bread menu.

Exhibit 5 Panera's Lineup of Bread Varieties, 2006

Sourdough

Panera's signature sourdough bread that featured a golden, crackled crust and firm, moderately structured crumb with a satisfying, tangy flavor. *Available in Baguette, Loaf, XL Loaf, Roll and Bread Bowl.*

Asiago Cheese

Chunks of Asiago cheese were added to the standard sourdough recipe and baked right in, with more Asiago cheese sprinkled on top. *Available in Demi and Loaf.*

Focaccia

A traditional Italian flatbread made with Panera's artisan starter dough, olive oil, and chunks of Asiago cheese. *Available in three varieties—Asiago Cheese, Rosemary & Onion and Basil Pesto.*

Nine Grain

Made with cracked whole wheat, rye, corn meal, oats, rice flour, soy grits, barley flakes, millet and flaxseed plus molasses for a semisweet taste. *Available in Loaf.*

Tomato Basil

A sourdough-based bread made with tomatoes and basil, topped with sweet walnut streusel. *Available in XL Loaf.*

Cinnamon Raisin

A light raisin bread with a swirl of cinnamon, sugar and molasses. *Available in Loaf.*

Artisan Sesame Semolina

Made with enriched durum and semolina flours to create a golden yellow crumb, topped with sesame seeds. *Available in Loaf and Miche.*

Artisan Multigrain

Nine grains and sesame, poppy and fennel seeds blended with molasses, topped with rolled oats. *Available in Loaf.*

Artisan French

Made with Panera's artisan starter to create a nutty flavor with a wine-like aroma. *Available in Baguette and Miche.*

Whole Grain

A moist, hearty mixture of whole spelt flour, millet, flaxseed and other wheat flours and grains, sweetened with honey and topped with rolled oats. *Available in loaf, miche and baguette.*

White Whole Grain

A new bread created especially for Panera Kids sandwiches; a sweeter alternative to the Whole Grain bread with a thin, caramelized crust sweetened with honey and molasses. *Available in Loaf.*

French

A classic French bread characterized by a thin, crackly crust, slightly sweet taste and a lighter crumb than our sourdough. *Available in Baguette, Loaf, XL Loaf and Roll.*

Ciabatta

A flat, oval-shaped loaf with a delicate flavor and soft texture; made with Panera's artisan starter and a touch of olive oil. *Available in Loaf.*

Honey Wheat

A mild wheat bread with tastes of honey and molasses; the soft crust and crumb made it great for sandwiches. *Available in Loaf.*

Rye

Special natural leavening, unbleached flour and chopped rye kernels were used to create a delicate rye flavor. *Available in Loaf.*

Sunflower

Made with honey, lemon peel and raw sunflower seeds and topped with sesame and honey-roasted sunflower seeds. *Available in Loaf.*

Artisan Three Seed

The addition of sesame, poppy and fennel seeds created a sweet, nutty, anise-flavored bread. *Available in Demi.*

Artisan Three Cheese

Made with Parmesan, Romano, and Asiago cheeses and durum and semolina flours. *Available in Demi, Loaf and Miche.*

Artisan Stone-Milled Rye

Made with Panera's artisan starter, chopped rye kernels and caraway seeds, topped with more caraway seeds. *Available in Loaf and Miche.*

Artisan Country

Made from artisan starter with a crisp crust and nutty flavor. *Available in loaf, miche and demi.*

Lower-Carb Pumpkin Seed

Made from Panera's artisan starter dough, pumpkin seeds and flax meal to create a subtle, nutty flavor. *Available in Loaf.*

Lower-Carb Italian Herb

Made from Panera's artisan starter dough, roasted garlic, dried herbs and sesame seed topping. *Available in Loaf.*

Exhibit 6 Sample Menu Selections, Panera Bread Company, 2006

Bakery

Loaves of Bread (22 varieties)
 Bagels (11 varieties)
 Cookies (5 varieties)
 Scones (5 varieties)
 Cinnamon Rolls Pecan Rolls
 Croissants
 Coffee Cakes
 Muffins (5 varieties)
 Artisan and Specialty Pastries (8 varieties)
 Brownies (3 varieties)
 Mini-Bundt Cakes (3 varieties)

Signature Sandwiches

Pepperblue Steak
 Garden Veggie
 Tuscan Chicken
 Asiago Roast Beef
 Italian Combo
 Bacon Turkey Bravo
 Sierra Turkey
 Turkey Romesco
 Mediterranean Veggie

Café Sandwiches

Smoked Turkey Breast
 Chicken Salad
 Tuna Salad
 Smoked Ham and Cheese

Hot Panini Sandwiches

Turkey Artichoke
 Frontega Chicken
 Smokehouse Turkey
 Portobello and Mozzarella

Baked Egg Souffles

Four Cheese
 Spinach and Artichoke
 Spinach and Bacon

Soups

Broccoli Cheddar
 French Onion
 Baked Potato
 Low Fat Chicken Noodle
 Cream of Chicken and Wild Rice
 Boston Clam Chowder
 Low Fat Vegetarian Garden Vegetable
 Low Fat Vegetarian Black Bean
 Vegetarian Roasted Red Pepper and Lentil
 Tuscan Chicken and Ditalini
 Tuscan Vegetable Ditalini

Hand Tossed Salads

Asian Sesame Chicken
 Fandango
 Greek
 Caesar
 Grilled Chicken Caesar
 Bistro Steak
 Classic Café
 California Mission Chicken
 Fuji Apple Chicken
 Strawberry Poppyseed and Chicken
 Grilled Salmon Salad

Side Choices

Portion of French Baguette
 Portion of Whole Grain Baguette
 Kettle-cooked or Baked Chips
 Apple

Panera Kids

Grilled Cheese
 Peanut Butter and Jelly
 Kids Deli

Beverages

Coffee
 Hot and Iced Teas
 Sodas
 Bottled Water
 Juice
 Organic Milk
 Organic Chocolate Milk
 Hot Chocolate
 Orange Juice
 Organic Apple Juice
 Espresso
 Cappuccino
 Lattes
 Mango Raspberry Smoothie

The menu offerings were regularly reviewed and revised to sustain the interest of regular customers, satisfy changing consumer preferences, and be responsive to various seasons of the year. The soup lineup, for example, changed seasonally. Product development was focused on providing food that customers would crave and trust to be tasty. New menu items were developed in test kitchens and then introduced in a limited number of the bakery-cafés to determine customer response and verify that preparation and operating procedures resulted in product consistency and high quality standards. If successful, they were then rolled out systemwide. New product rollouts were integrated into periodic or seasonal menu rotations, which Panera referred to as “Celebrations.”

Panera recognized in late 2004 that significantly more customers were conscious about eating “good” carbohydrates, prompting the introduction of whole grain breads. In 2005, several important menu changes were made. Panera introduced a new line of artisan sweet goods made with gourmet European butter, fresh fruit toppings, and appealing fillings; these new artisan pastries represented a significantly higher level of taste and upgraded quality. To expand its breakfast offerings and help boost morning-hour sales, Panera introduced egg soufflés baked in a flaked pastry shell. And, in another health-related move, Panera switched to the use of natural, antibiotic-free chicken in all of its chicken-related sandwiches and salads. During 2006, the chief menu changes involved the addition of light entrées to jump-start dinner appeal; one such menu addition was crispani (a pizzalike topping on a thin crust). In 2006, evening-hour sales represented 20 percent of Panera’s business.

PANERA FRESH CATERING

In 2004–2005, Panera Bread introduced a catering program to extend its market reach into the workplace, schools, parties, and gatherings held in homes. Panera saw catering as an opportunity to grow lunch and dinner sales with making capital investments in additional physical facilities. By the end of 2005, catering was generating an additional \$80 million in sales

for Panera Bread. Management foresaw considerable opportunity for future growth of Panera’s catering operation.

MARKETING

Panera’s marketing strategy was to compete on the basis of providing an entire dining experience rather than by attracting customers on the basis of price only. The objective was for customers to view dining at Panera as being a good value—meaning high-quality food at reasonable prices—so as to encourage frequent visits. Panera Bread performed extensive market research, including the use of focus groups, to determine customer food and drink preferences and price points. The company tried to grow sales at existing Panera locations through menu development, product merchandising, promotions at everyday prices, and sponsorship of local community charitable events.

Historically, marketing had played only a small role in Panera’s success. Brand awareness had been built on customers’ satisfaction with their dining experience at Panera and their tendency to share their positive experiences with friends and neighbors. About 85 percent of consumers who were aware that there was a Panera Bread bakery-café in their community or neighborhood had dined at Panera on at least one occasion.³ The company’s marketing research indicated that 57 percent of consumers who had “ever tried” dining at Panera Bread had been customers in the past 30 days. This high proportion of trial customers to repeat customers had convinced management that getting more first-time diners into Panera Bread cafés was a potent way to boost store traffic and average weekly sales per store.

Panera’s research also showed that people who dined at Panera Bread very frequently or moderately frequently typically did so for only one part of the day. Yet 81 percent indicated “considerable willingness” to try dining at Panera Bread at other parts of the day.⁴

Franchise-operated bakery-cafés were required to contribute 0.7 percent of their sales to a national advertising fund and 0.4 percent of their sales as a marketing administration fee and were also required to spend 2.0 percent of their sales in their local

markets on advertising. Panera contributed similar amounts from company-owned bakery-café toward the national advertising fund and marketing administration. The national advertising fund contribution of 0.7 percent had been increased from 0.4 percent starting in 2006. Beginning in fiscal 2006, national advertising fund contributions were raised to 0.7 percent of sales, and Panera could opt to raise the national advertising fund contributions as high as 2.6 percent of sales.

In 2006, Panera Bread's marketing strategy had several elements. One element aimed at raising the quality of awareness about Panera by continuing to feature the caliber and appeal of its breads and baked goods, by hammering the theme "food you crave, food you can trust," and by enhancing the appeal of its bakery-café as a neighborhood gathering place. A second marketing initiative was to raise awareness and boost trial of dining at Panera Bread at multiple meal times (breakfast, lunch, "chill out" times, and dinner). Panera avoided hard-sell or in-your-face marketing approaches, preferring instead to employ a range of ways to softly drop the Panera Bread name into the midst of consumers as they moved through their lives and let them "gently collide" with the brand; the idea was to let consumers "discover" Panera Bread and then convert them into loyal customers by providing a very satisfying dining experience. The third marketing initiative was to increase perception of Panera Bread as a viable evening meal option and to drive early trials of Panera for dinner (particularly among existing Panera lunch customers).

Franchise Operations

Opening additional franchised bakery-café was a core element of Panera Bread's strategy and management's initiatives to achieve the company's growth targets. Panera Bread did not grant single-unit franchises, so a prospective franchisee could not open just one bakery-café. Rather, Panera Bread's franchising strategy was to enter into franchise agreements that required the franchise developer to open a number of units, typically 15 bakery-café in six years. Franchisee candidates had to be well capitalized, have a proven track record as excellent multi-unit restaurant operators, and agree to meet an aggressive development schedule. Applicants had to

meet eight stringent criteria to gain consideration for a Panera Bread franchise:

- Experience as a multi-unit restaurant operator.
- Recognition as a top restaurant operator.
- Net worth of \$7.5 million.
- Liquid assets of \$3 million.
- Infrastructure and resources to meet Panera's development schedule for the market area the franchisee was applying to develop.
- Real estate experience in the market to be developed.
- Total commitment to the development of the Panera Bread brand.
- Cultural fit and a passion for fresh bread.

The franchise agreement typically required the payment of a franchise fee of \$35,000 per bakery-café (broken down into \$5,000 at the signing of the area development agreement and \$30,000 at or before a bakery-café opened) and continuing royalties of 4–5 percent on sales from each bakery-café. Franchise-operated bakery-café followed the same standards for in store operating standards, product quality, menu, site selection, and bakery-café construction as did company-owned bakery-café. Franchisees were required to purchase all of their dough products from sources approved by Panera Bread. Panera's fresh dough facility system supplied fresh dough products to substantially all franchise-operated bakery-café. Panera did not finance franchisee construction or area development agreement payments or hold an equity interest in any of the franchise-operated bakery-café. All area development agreements executed after March 2003 included a clause allowing Panera Bread the right to purchase all bakery-café opened by the franchisee at a defined purchase price, at any time five years after the execution of the franchise agreement.

Exhibit 7 shows estimated costs of opening a new franchised Panera Bread bakery-café. As of 2006, the typical franchise-operated bakery-café averaged somewhat higher average weekly and annual sales volumes than company-operated café (see Exhibit 2), was equal to or slightly more profitable, and produced a slightly higher return on equity investment than company-operated café (partly because many franchisees made greater use of debt in financing their operations than did Panera, which

Exhibit 7 Estimated Initial Investment for a Panera Bread Bakery-Café, 2007

| Investment Category | Actual or Estimated Amount | To Whom Paid |
|--|---|--|
| Franchise fee | \$35,000 | Panera |
| Real property | Varies according to site and local real estate market conditions | |
| Leasehold improvements | \$350,000 to \$1,250,000 | Contractors |
| Equipment | \$250,000 to \$300,000 | Equipment vendors, Panera |
| Fixtures | \$60,000 to \$90,000 | Vendors |
| Furniture | \$50,000 to \$70,000 | Vendors |
| Consultant fees and municipal impact fees (if any) | \$20,000 to \$120,000 | Architect, engineer, expeditor, others |
| Supplies and inventory | \$19,000 to \$24,175 | Panera, other suppliers |
| Smallwares | \$24,000 to \$29,000 | Suppliers |
| Signage | \$20,000 to \$72,000 | Suppliers |
| Additional funds (for working capital and general operating expenses for 3 months) | \$175,000 to \$245,000 | Vendors, suppliers, employees, utilities, landlord, others |
| Total | \$1,003,000 to \$2,235,175, plus real estate and related costs | |

Source: www.panerabread.com (accessed February 9, 2007).

had no long-term debt at all).⁵ During the 2003–2006 period, in four unrelated transactions, Panera purchased 38 bakery-café from franchisees.

Panera provided its franchisees with market analysis and site selection assistance, lease review, design services and new store opening assistance, a comprehensive 10-week initial training program, a training program for hourly employees, manager and baker certification, bakery-café certification, continuing education classes, benchmarking data regarding costs and profit margins, access to company developed marketing and advertising programs, neighborhood marketing assistance, and calendar planning assistance. Panera's surveys of its franchisees indicated high satisfaction with the Panera Bread concept, the overall support received from Panera Bread, and the company's leadership. The biggest franchisee issue was the desire for more territory. In turn, Panera management expressed satisfaction with the quality of franchisee operations, the pace and quality of new bakery-café openings, and franchisees' adoption of Panera Bread initiatives.⁶

As of April 2006, Panera had entered into area development agreements with 42 franchisee groups covering 54 markets in 34 states; these franchisees had commitments to open 423 additional franchise-operated bakery-café. If a franchisee failed to develop bakery-café on schedule, Panera had the right

to terminate the franchise agreement and develop its own company-operated locations or develop locations through new area developers in that market. As of mid-2006, Panera Bread did not have any international franchise development agreements but was considering entering into franchise agreements for several Canadian locations (Toronto and Vancouver).

SITE SELECTION AND CAFÉ ENVIRONMENT

Bakery-café were typically located in suburban, strip mall, and regional mall locations. In evaluating a potential location, Panera studied the surrounding trade area, demographic information within that area, and information on competitors. Based on analysis of this information, including the use of predictive modeling using proprietary software, Panera developed projections of sales and return on investment for candidate sites. Cafés had proved successful as freestanding units, as both in-line and end-cap locations in strip malls, and in large regional malls.

The average Panera bakery-café was approximately 4,600 square feet. The great majority of the locations were leased. Lease terms were typically for 10 years with one, two, or three 5-year renewal option

periods thereafter. Leases typically entailed charges for minimum base occupancy, a proportionate share of building and common-area operating expenses and real estate taxes, and a contingent percentage rent based on sales above a stipulated sales level. The average construction, equipment, furniture and fixture, and signage cost for the 66 company-owned bakery-café opened in 2005 was \$920,000 per bakery-café after landlord allowances.

Each bakery-café sought to provide a distinctive and engaging environment (what management referred to as “Panera Warmth”), in many cases using fixtures and materials complementary to the neighborhood location of the bakery-café. In 2005–2006, the company had introduced a new G2 café design aimed at further refining and enhancing the appeal of Panera bakery-café as a warm and appealing neighborhood gathering place (a strategy that Starbucks had used with great success). The G2 design incorporated higher-quality furniture, cozier seating areas and groupings, and a brighter, more open display case. Many locations had fireplaces to further create an alluring and hospitable atmosphere that patrons would flock to on a regular basis, sometimes for a meal, sometimes to meet friends and acquaintances for a meal, sometimes to take a break for a light snack or beverage, and sometimes to just hang out with friends and acquaintances. Many of Panera’s bakery-café had outdoor seating, and virtually all cafés featured free wireless high-speed (Wi-Fi) Internet access—Panera considered free Wi-Fi part of its commitment to making its bakery-café open community gathering places where people could catch up on some work, hang out with friends, read the paper, or just relax. All Panera cafés used real china and stainless silverware instead of paper plates and plastic utensils.

BAKERY-CAFÉ SUPPLY CHAIN

Panera had invested about \$52 million in a network of 17 regional fresh dough facilities (16 company-owned and one franchise-operated) to supply fresh dough daily to both company-owned and franchised bakery-café. These facilities, totaling some 313,000 square feet, employed about 830 people who were largely engaged in preparing the fresh doughs, a

process that took about 48 hours. The dough-making process began with the preparation and mixing of Panera’s all-natural starter dough, which then was given time to rise; other all-natural ingredients were then added to create the different bread and bagel varieties (no chemicals or preservatives were used). Another period of rising then took place. Next the dough was cut into pieces, shaped into loaves or bagels, and readied for shipment in fresh dough form. There was no freezing of the dough, and no partial baking was done at the fresh dough facilities. Each bakery-café did all of the baking itself, using the fresh doughs delivered daily. The fresh dough facilities manufactured about 50 different products, with 11 more rotated throughout the year.

Distribution of the fresh bread and bagel doughs was accomplished through a leased fleet of about 140 temperature-controlled trucks operated by Panera personnel. Trucks on average delivered dough to six bakery-café, with trips averaging about 300 miles (but in some cases extending to as much as 500 miles—management believed the optimal trip length was about 300 miles). The fresh dough was sold to both company-owned and franchised bakery-café at a delivered cost not to exceed 27 percent of the retail value of the product. Exhibit 8 provides financial data relating to each of Panera’s three business segments: company-operated bakery-café, franchise operations, and fresh dough facilities. The sales and operating profits associated with the fresh doughs supplied to company-operated bakery-café are included in the revenues and operating profits of the company-owned bakery-café segment. The sales and operating profits of the fresh dough facilities segment shown in Exhibit 8 all represent transactions with franchised bakery-café.

Management claimed that the company’s fresh-dough-making capability provided a competitive advantage by ensuring consistent quality and dough-making efficiency. It was more economical to concentrate the dough-making operations in a few facilities dedicated to that function than it was to have each bakery-café equipped and staffed to do all of its baking from scratch.

Panera obtained ingredients for its doughs and other products manufactured at the fresh dough facilities from a variety of suppliers. While some ingredients used at the fresh dough facilities were sourced from a single supplier, there were numerous suppliers of each ingredient and Panera could obtain

Exhibit 8 Business Segment Information, Panera Bread Company, 2003–2006
(\$ in thousands)

| | 2006 | 2005 | 2004 | 2003 |
|---------------------------------------|-----------|-----------|-----------|-----------|
| Segment revenues: | | | | |
| Company bakery-café operations | \$666,141 | \$499,422 | \$362,121 | \$265,933 |
| Franchise operations | 61,531 | 54,309 | 44,449 | 36,245 |
| Fresh dough operations | 159,050 | 128,422 | 103,786 | 93,874 |
| Intercompany sales eliminations | (57,751) | (41,878) | (31,217) | (32,350) |
| Total revenues | \$828,971 | \$640,275 | \$479,139 | \$363,702 |
| Segment operating profit: | | | | |
| Company bakery-café operations | \$123,225 | \$ 97,831 | \$ 71,725 | \$ 55,111 |
| Franchise operations | 54,160 | 47,652 | 39,149 | 32,132 |
| Fresh dough operations | 15,681 | 11,508 | 6,942 | 6,557 |
| Total segment operating profit | \$193,066 | \$156,991 | \$117,816 | \$ 93,800 |
| Depreciation and amortization: | | | | |
| Company bakery-café operations | \$ 32,741 | \$ 23,345 | \$ 17,786 | \$ 12,256 |
| Fresh dough operations | 7,097 | 6,016 | 4,356 | 3,298 |
| Corporate administration | 4,328 | 3,650 | 3,156 | 2,750 |
| Total | \$ 44,166 | \$ 33,011 | \$ 25,298 | \$ 18,304 |
| Capital expenditures | | | | |
| Company bakery-café operations | \$ 86,743 | \$ 67,554 | \$ 67,374 | \$ 33,670 |
| Fresh dough operations | 15,120 | 9,082 | 9,445 | 8,370 |
| Corporate administration | 7,433 | 5,420 | 3,610 | 3,721 |
| Total capital expenditures | \$109,296 | \$ 82,056 | \$ 80,429 | \$ 45,761 |
| Segment assets | | | | |
| Company bakery-café operations | \$374,795 | \$301,517 | \$204,295 | \$147,920 |
| Franchise operations | 3,740 | 2,969 | 1,778 | 1,117 |
| Fresh dough operations | 59,919 | 37,567 | 39,968 | 33,442 |
| Other assets | 104,155 | 95,614 | 78,631 | 74,356 |
| Total assets | \$542,609 | \$437,667 | \$324,672 | \$256,835 |

Sources: Company 10-K reports, 2004, 2005, and 2006.

ingredients from another supplier when necessary. Panera contracted externally for the supply of sweet goods to its bakery-café. In November 2002, it entered into a cost-plus agreement with Dawn Food Products Inc. to provide sweet goods for the period 2003–2007. Sweet goods were completed at each bakery-café by professionally trained bakers—completion entailed finishing with fresh toppings and other ingredients and baking to established artisan standards.

Panera had arrangements with independent distributors to handle the delivery of sweet goods and other materials to bakery-café. Virtually all other food products and supplies for retail operations, including paper goods, coffee, and smallwares, were contracted for by Panera and delivered by the vendors to the designated distributors for delivery to the

bakery-café. Individual bakery-café placed orders for the needed supplies directly from a distributor two to three times per week. Franchise-operated bakery-café operate under individual contracts with one of Panera's three primary independent distributors or other regional distributors.

COMPETITION

According to the National Restaurant Association, sales at the 925,000 food service locations in the United States were forecast to be about \$511 billion in 2006 (up from \$308 billion in 1996), and account for 47.5 percent of consumers' food dollars (up from 25 percent in 1955). Commercial eating places accounted for about \$345 billion of the projected

\$511 billion in total food service sales, with the remainder divided among drinking places, lodging establishments with restaurants, managed food service locations, and other types of retail, vending, recreational, and mobile operations with food service capability. The U.S. restaurant industry had about 12.5 million employees in 2006, served about 70 billion meals and snack occasions, and was growing about 5 percent annually.⁷ Just over 7 out of 10 eating and drinking places in the United States were independent single-unit establishments with fewer than 20 employees.

Even though the average U.S. consumer ate 76 percent of meals at home, on a typical day, about 130 million U.S. consumers were food service patrons at an eating establishment—sales at commercial eating places averaged close to \$1 billion daily. Average household expenditures for food away from home in 2004 were \$2,434, or \$974 per person. In 2003, unit sales averaged \$755,000 at full-service restaurants and \$606,000 at limited-service restaurants; however, very popular restaurant locations achieved annual sales volumes in the \$2.5 million to \$5 million range. The profitability of a restaurant location ranged from exceptional to good to average to marginal to money-losing.

The restaurant business was labor-intensive, extremely competitive, and risky. Industry members pursued differentiation strategies of one variety of

another, seeking to set themselves apart from rivals via pricing, food quality, menu theme, signature menu selections, dining ambience and atmosphere, service, convenience, and location. To further enhance their appeal, some restaurants tried to promote greater customer traffic via happy hours, lunch and dinner specials, children's menus, innovative or trendy dishes, diet-conscious menu selections, and beverage/appetizer specials during televised sporting events (important at restaurants/bars with big-screen TVs). Most restaurants were quick to adapt their menu offerings to changing consumer tastes and eating preferences, frequently featuring heart-healthy, vegetarian, organic, low-calorie, and/or low-carb items on their menus. It was the norm at many restaurants to rotate some menu selections seasonally and to periodically introduce creative dishes in an effort to keep regular patrons coming back, attract more patrons, and remain competitive.

Consumers (especially those who ate out often) were prone to give newly-opened eating establishments a trial, and if they were pleased with their experience to return, sometimes frequently—loyalty to existing restaurants was low when consumers perceived there were better dining alternatives. It was also common for a once-hot restaurant to lose favor and confront the stark realities of a dwindling clientele, forcing it to either reconceive its menu and dining environment or go out of business. Many

Exhibit 9 **Representative Fast-Casual Restaurants Chains and Selected Full-Service Restaurant Chains in the United States, 2006**

| Company | Number of Locations, 2005–2006 | Select 2005 Financial Data | Key Menu Categories |
|--|--|---|--|
| Atlanta Bread Company | 160 bakery-café in 27 states | Not available (privately-held company) | Fresh-baked breads, waffles, salads, sandwiches, soups, wood-fired pizza and pasta (select locations only), baked goods, desserts |
| Applebee's Neighborhood Grill and Bar* | 1,730+ locations in 49 states, plus some 70 locations in 16 other countries | 2005 revenues of \$1.2 billion; average annual sales of \$2.5 million per location; alcoholic beverages accounted for about 12 percent of sales | Beef, chicken, pork, seafood, and pasta entrées plus appetizers, salads, sandwiches, a selection of Weight Watchers branded menu alternatives, desserts, and alcoholic beverages |
| Au Bon Pain | 190 company-owned and franchised bakery-café in 23 states; 222 locations internationally | Systemwide sales of about \$245 million in 2005 | Baked goods (with a focus on croissants and bagels), soups, salads, sandwiches and wraps, and coffee drinks |

(Continued)

Exhibit 9 Continued

| Company | Number of Locations, 2005–2006 | Select 2005 Financial Data | Key Menu Categories |
|--|--|--|--|
| Baja Fresh | 300+ locations across the United States | A subsidiary of Wendy's International | Tacos, burritos, quesadilla, fajitas, salads, soups, sides, and catering services |
| Bruegger's | 260 bakery-café in 17 states | 2005 revenues of \$155.2 million; 3,500 full-time employees | Several varieties of bagels and muffins, sandwiches, salads, and soups |
| California Pizza Kitchen* | 190+ locations in 27 states and 5 other countries | 2005 revenues of \$480 million; average annual sales of \$3.2 million per location | Signature California-style hearth-baked pizzas; creative salads, pastas, soups and sandwiches; appetizers; desserts, beer, wine, coffees, teas, and assorted beverages |
| Chili's Grill and Bar* (a subsidiary of Brinker International**) | 1,074 locations in 49 states and 23 countries | Average revenue per meal of ≈\$12.00; average capital investment of \$2.4 million per location | Chicken, beef, and seafood entrées, steaks, appetizers, salads, sandwiches, desserts, and alcoholic beverages (13.6 percent of sales) |
| Chipotle Mexican Grill | 500+ locations (all company-owned) | 2005 sales of \$628 million; 13,000 employees | A selection of gourmet burritos and tacos |
| Corner Bakery Café (a subsidiary of Brinker International**) | 90 locations in 8 states and District of Columbia | Average revenue per meal of ≈\$7.44; average capital investment of \$1.7 million per location | Breakfast selections (egg scramblers, pastries, mixed berry parfaits); lunch/diner selections (hot and cold sandwiches, salads, soups, and desserts); catering (≈21 percent of sales) |
| Cracker Barrel | 527 combination retail stores and restaurants in 42 states | Restaurant sales of \$2.1 billion in 2005; average restaurant sales of \$3.3 million | Two menus (breakfast and lunch/dinner); named "Best Family Dining Chain" for 15 consecutive years |
| Culver's | 330 locations in 16 states | Not available (a privately held company) | Signature hamburgers served on buttered buns, fried battered cheese curds, value dinners (chicken, shrimp, cod with potato and slaw), salads, frozen custard, milkshakes, sundaes, and fountain drinks |
| Fazoli's | 380 locations in 32 states | Not available (a privately held company) | Spaghetti and meatballs, fettuccine Alfredo, lasagna, ravioli, submarinos and panini sandwiches, salads, and breadsticks |
| Fuddruckers | 200+ locations in the United States and 6 Middle Eastern countries | Not available (a privately held company) | Exotic hamburgers (the feature menu item), chicken and fish sandwiches, French fries and other sides, soups, salads, desserts |
| Jason's Deli | 150 locations in 20 states | Not available (a privately held company) | Sandwiches, extensive salad bar, soups, loaded potatoes, desserts; catering services, party trays, and box lunches |
| McAlister's Deli | 200+ locations in 18 states | Not available (a privately held company) | Deli sandwiches, loaded baked potatoes, soups, salads, and desserts, plus sandwich trays and lunch boxes |

(Continued)

| Company | Number of Locations, 2005–2006 | Select 2005 Financial Data | Key Menu Categories |
|-----------------------------|--|---|--|
| Moe's Southwest Grill | 200+ locations in 35 states | Not available (a privately-held company) | Tex-Mex foods prepared fresh—tacos, burritos, fajitas, quesadillas, nachos, salads, chips and salsa |
| Noodles & Company | 120+ urban and suburban locations in 16 states | Not available (a privately-held company) | Asian, Mediterranean and American noodle/pasta entrées, soups and salads |
| Nothing But Noodles | 39 locations in 20 states | Not available (a privately-held company) | Starters, a wide selection of American and Italian pastas, Asian dishes with noodles, pasta-less entrées, soups, salads, and desserts |
| Qdoba Mexican Grill | 280+ locations in 40 states | A subsidiary of Jack in the Box, Inc.; Jack in the Box had 2005 revenues of \$2.5 billion, 2,300+ Jack in the Box and Qdoba locations, and 44,600 employees | Signature burritos, a "Naked Burrito" (a burrito served in a bowl without the tortilla), nontraditional taco salads, three-cheese nachos, five signature salsas, and a Q-to-Go Hot Taco Bar catering alternative |
| Rubio's Fresh Mexican Grill | 150 locations in 5 western states | 2005 revenues of \$141 million; average sales of \$960,000 per location | Signature fish tacos; chicken beef, and pork tacos; burritos and quesadillas; salads; proprietary salsas; sides; and domestic and imported beers |
| Starbucks | 7,500+ company-operated and licensed locations in the United States, plus ≈3,000 international locations | 2005 revenues of \$6.4 billion; estimated retail sales of \$1.1 million per company-operated location | Italian-style espresso beverages, teas, sodas, juices, assorted pastries and confections; some locations offer sandwiches and salads |

* Denotes a full-service restaurant.

** Brinker International was a multi-concept restaurant operator with over 1,500 restaurants including Chili's Grill & Bar, Chili's Too, Corner Bakery Café, Romano's Macaroni Grill, On the Border Mexican Grill & Cantina, and Maggiano's Little Italy. Brinker had 2005 sales of \$3.9 billion.

Sources: Company Web sites and en.wikipedia.org/wiki/Fast_casual_restaurant (accessed August 2, 2006).

restaurants had fairly short lives; there were multiple causes for a restaurant's failure—a lack of enthusiasm for the menu or dining experience, inconsistent food quality, poor service, a bad location, meal prices that patrons deemed too high, and superior competition by rivals with comparable menu offerings.

While Panera Bread competed with specialty food, casual dining, and quick-service restaurant retailers—including national, regional, and locally owned restaurants—its closest competitors were restaurants in the so-called fast-casual restaurant

category. Fast-casual restaurants filled the gap between fast-food and casual, full-table-service dining. A fast-casual restaurant provided quick-service dining (much like fast-food enterprises) but were distinguished by enticing menus, higher food quality, and more inviting dining environments; typical meal costs per guest were in the \$7–\$12 range. Some fast-casual restaurants had limited table service and some were self-service (like fast-food establishments). Exhibit 9 provides information on prominent national and regional chains that were competitors of Panera Bread.

Endnotes

¹ According to information in Panera Bread's press kit; the results of the study were reported in a 2003 *Wall Street Journal* article.

² As stated in a presentation to securities analysts, May 5, 2006.

³ As cited in Panera Bread's presentation to securities analysts on May 5, 2006.

⁴ *Ibid.*

⁵ *Ibid.*

⁶ *Ibid.*

⁷ Information posted at www.restaurant.org (accessed August 1, 2006).