Case 7

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-cafés 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-cafés open by the end of 2010. Management was confident that Panera Bread's attractive menu and the dining ambience of its bakery-cafés 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-cafés 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-cafés 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-cafés and a debt-free balance sheet.

Between January 1999 and December 2006, close to 850 additional Panera Bread bakery-cafés 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-cafés 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-cafés open at year-end	391	311	226	173	132	110	90
Franchised bakery-cafés open at year-end	636	566	515	429	346	259	172
Total bakery-cafés 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-cafés 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.*

Source: www.panerabread.com (accessed July 28, 2006).

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

Source: Sample menu posted at www.panerabread.com (accessed July 29, 2006).

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-cafés 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-cafés 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-cafés 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-cafés 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-cafés followed the same standards for in store operating standards, product quality, menu, site selection, and bakery-café construction as did company-owned bakery-cafés. 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-cafés. Panera did not finance franchisee construction or area development agreement payments or hold an equity interest in any of the franchise-operated bakery-cafés. All area development agreements executed after March 2003 included a clause allowing Panera Bread the right to purchase all bakery-cafés 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 cafés (see Exhibit 2), was equal to or slightly more profitable, and produced a slightly higher return on equity investment than company-operated cafés (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-cafés 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-cafés. If a franchisee failed to develop bakery-cafés 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-cafés 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-cafés 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-cafés 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-cafés 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-cafés 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-cafés. 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-cafés, 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-cafés 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-cafés, franchise operations, and fresh dough facilities. The sales and operating profits associated with the fresh doughs supplied to company-operated bakery cafés 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-cafés.

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-cafés. 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-cafés. 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-cafés. Individual bakery-cafés placed orders for the needed supplies directly from a distributor two to three times per week. Franchise-operated bakery-cafés 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-cafés 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-cafés 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-cafés 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).