StockWatch by Michael Nuckolls

The Parent-Child Relationship

Subsidiary chains grow up fast but hold a casual presence on income statements.

It's hard to stand in a room with anyone who has anything to do with restaurants and not get into an intense discussion about what fast-casual is, who is or is not one, and how can we all profit in the growing segment.

Panera Bread (NASDAQ: PNRA) and Buffalo Wild Wings are doing it the way grandpa always taught—work hard and give it your best. KFC and Subway are employing PR spin doctors. But there are others who simply embrace the old American adage, "If you can't beat 'em, buy 'em."

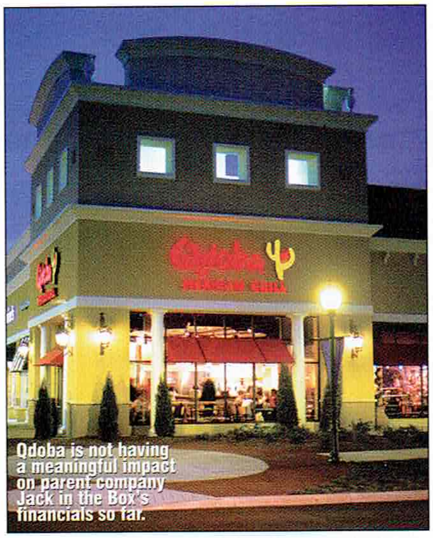
McDonald's (NYSE: MCD) set the trend by buying an interest in Denver-based Chipotle from founder Steve Ells in early 1998. GE Franchise Finance estimates Chipotle's 2002 systemwide sales at $243 million, up 31 percent over 2001. Impressive gains for a 10-year-old chain but still only 1.4 percent of the systemwide sales posted for *domestic* McDonald's restaurants. There are more McDonald's within a 25-mile-radius of Chicago than there are Chipotle units nationwide.

One could get the impression that this parent wasn't proud of the kids. McDonald's lesser chains are all lumped under the faceless title "Partner Brands." Chipotle was virtually unmentioned in the 2002 corporate annual report, garnering a passing credit for its rapid expansion and positive comparable store sales.

CKE Restaurants (NYSE: CKR), franchiser and operator of Carl's Jr. and Hardee's, landed the 95-unit La Salsa chain in its $78.8 million purchase of Santa Barbara Restaurant Group in March 2002. La Salsa systemwide sales of $62.3 million are a paltry 2.2 percent of the almost $3 billion in sales of the combined Carl's Jr. and Hardee's chains.

La Salsa might appear to be the neglected child of CKE. In the first 15 months, La Salsa grew 4 percent, contrasting with over 30 percent at Chipotle and Baja Fresh in 2002. Systemwide sales growth declined from 2.5 percent in fiscal 2002 to 0.8 percent in fiscal 2003 (ending January 2003). In the first fiscal year with CKE, La Salsa fell from $292,000 in income in the first quarter to a loss of $580,000 in the fourth.

As La Salsa and Green Burrito executive vice president and COO Mike Liby explains, CKE is in the process of repositioning La Salsa from what was a taqueria. "Our primary goal is to get ourselves positioned with the new prototype to quick-casual," Liby says. With the new prototype La Salsa will be aggressively seeking franchise partners to expand beyond the core California and Nevada markets and give CKE an opportunity to compete in Mexican fast-casual.



Qdoba is not having a meaningful impact on parent company Jack in the Box's financials so far.

When Wendy's (NYSE: WEN) went on the prowl, it was searching for the pick of the litter. After reportedly "reviewing hundreds of concepts," the 169-unit Baja Fresh Mexican Grill was purchased in June 2002.

Baja Fresh leads the fast-casual Mexican segment with $249 million in systemwide sales from more than 225 units. In the six months under Wendy's ownership in 2002, Baja Fresh contributed a small but positive 2.5 percent to revenues. Even with a chain growing systemwide sales increase of 40 percent in 2002, it still only added 0.5 percent to Wendy's income. Although interest expenses related to the purchase led to a dilution of EPS by $0.04 in 2002 and is expected to be "slightly dilutive" in 2003, Wendy's says Baja will be accretive to earnings in 2004.

Baja Fresh won't affect Wendy's that much in the near future but the company has high hopes. Analyst Mark Kalinowski of Citigroup reports that the company expects Baja Fresh will increase EPS by 13–15 cents by 2007. There's no doubt this chain is being nurtured to follow in the parent company's footsteps of healthy business.

Perhaps feeling the clock ticking, Jack in the Box (NYSE: JBX) announced the $45 million purchase of the 85-unit Qdoba Mexican Grill concept in January of this year. Qdoba had $65 million in systemwide sales and 12 percent same store sales growth in 2002. Still, the chain represented only 0.7 percent of total Jack in the Box consolidated operating earnings in the quarter ended April 13, 2003.

Jack in the Box spokesperson Karen Bachmann confirmed that Qdoba is not having a meaningful impact on financials in the near term. The company expects it to be "somewhat accretive in the next few years," though. Hard to say at this point but Qdoba certainly has a better chance of standing outside the shadow of its less dominating parent.

So what do these new additions to the families mean for investors? At this point, not much. In a December 2002 report on fast-casuals, Kalinowski wrote, "The problem for McDonald's investors is that brand McDonald's is so large…that, in our view, it is unwise to invest in the corporation's stock solely because of its fast-casual presence." The same could be said of CKE, Wendy's, and Jack in the Box.

The verdict? Don't invest based on the number of times you hear or read the term fast-casual describing a company. Take into account these parents are forward-thinking and may grow successful underlings. Take into account that the performance of the subsidiaries may indicate the health of the parent company. And as always, buy smart.

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