Financial Analysis Project: P.F. Chang's China Bistro, Inc.

Stock Symbol: PFCB

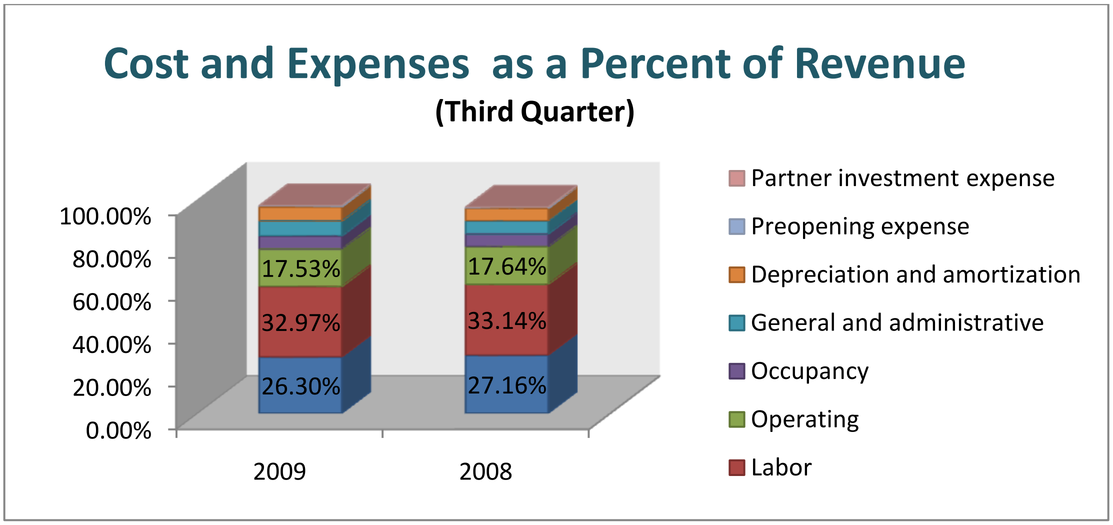
Bruce Yodis

Due: January 27, 2010

Hospitality and Restaurant Accounting I

P.F. Chang's China Bistro, Inc. was founded in 1996 and is based in Scottsdale, Arizona. It owns and operates two restaurant concepts, P.F. Chang's China Bistro and Pei Wei Asian Diner. The first Bistro restaurant opened in Scottsdale, AZ in 1993 and the first Pei Wei restaurant made its debut in the Phoenix-metro area in 2000. As of December 28, 2008, it operated 189 full service Bistro restaurants and 159 quick, casual Pei Wei restaurants. All restaurants are currently in the United States; however, they are pursuing licensing agreements with international partners.[1] P.F. Chang's China Bistro is a full service upscale casual dining restaurant chain that feature a blend of high-quality, traditional Chinese cuisine and attentive service, in a high-energy contemporary bistro setting. Pei Wei Asian Diner is a chain of quick-casual restaurants that serve freshly prepared, wok-seared, contemporary pan-Asian cuisine at a lower value point.[2]

The third quarter 2009 Income statement for P.F. Chang's shows that revenue was down $5,548 million from the third quarter 2008 but gross profit was down only $1,544 million. The total costs and expenses were up about half a percentage point. However, this increase is due to an increase in the fixed expenses, the costs and controllable operating expenses each decreased from 2008 third quarter as seen in the chart below.



Due to this decrease in controllable expenses, the efficiency ratio is at 0.23 compared to 0.22 for the third quarter a year ago, showing that the restaurants seems to be operating more efficiently despite the lower revenue. Net income increased for the third quarter this year mostly due to $4.7 million loss due to discontinued operations in the third quarter last year. This resulted in an increase in profit margin from 1.0% last year to 2.14% this year. YTD results also show that while total revenue has decreased, the controllable costs and expenses have been reduced, resulting in a YTD efficiency ratio of 0.241 compared to the 2008 YTD efficiency ratio of 0.228.

Wall Street reacted to this news in a negative way, sending the stock down $5.22 from $35.50 to $30.28 in one day. This is due to the fact that restaurant sales are still seen to be slumping across the board. Also, P.F. Chang's missed its profit outlook, and even though they upped their profit outlook it was well below the market consensus. Also, investors were very concerned with the decline of 8.5% in same-store sales at its namesake stores.[3] Wall Street seems to react with a knee-jerk reaction to year-over-year sales figures when looking at restaurants. Looking at Q1 2009 there was a $5.54 stock rise the day the Q1 results came out showing a $4.1M year-over-year increase in sales. The Q2 income statement revealed that year-over-year sales had stayed flat, therefore, the stock also stayed flat. However, once the full financials are studied these reactions are evened out and we now see the stock has bounced back and is currently around $38-$40 per share.

The balance sheet shows that, as of the end of the 3rd quarter, the assets had decreased $44.1M from the end of 2008. This is due to a $17.9M decrease in cash, $10.2M decrease in other current assets, and a $16.8M decrease in net property and equipment. Liabilities decreased by $50.5M due in large part to a $41.2M decrease in long term debt as well as a decrease of $5.2M in accrued expenses and $7.1M decrease in unearned revenue. It looks like they used this opportunity to pay off debt, thus reducing their overall liabilities (and assets as well). The company's equity only increased by $6.45M which was generally affected by two items. First, the retained earnings increased by $31.2M to $252,241M. Secondly, the company seems to be on a stock buyback program resulting in a decrease in treasury stock, at cost, of $29.2M (they repurchased 1.1 million shares in the first three quarters of this year). Additionally, an increase of $7.3M from additional paid-in capital caused the total equity value to increase.

It seems that the liabilities are being decreased due to a long term debt payoff plan and total equity values are fueled by an increase in retained earnings as well as a stock buyback program. The debt to equity ratio at the beginning of the year was 1.026 but at the end of the first three quarters for 2009 has decreased to 0.86. If we adjust the ratio for the repurchased stock price that the equity was reduced by, the debt to equity ratio looks even better at 0.61.[4]

So, just looking at the balance sheet we see a mix of things to consider. First, the assets have decreased causing the current ratio to be low (0.62) which means it does not have the cash available for liquidity. However, the solvency ratio has increased from 1.97 to 2.17 at the end of Q3 2009 due to reduced long term debt. Therefore, the company does have the ability to pay off its current and long term debt. Also, the company's debt-to-equity ratio is below one which is also a good sign. In order to invest we would need to do some more research. Some of the numbers look good but the inability to liquidate is a concern.

The cash flow statement for YTD (3 quarters) is showing a negative cash flow of $17.9M compared to a negative cash flow of only $91,000 last year at the same time. While cash for operating expenses stayed relatively flat, there was a reduction in capital expenditures of $30.6M YTD this year due to the opening of fewer stores. Fueling an increase of $47,4M in financing activities was $45.4M in repayment of long-term debt and the stock repurchase program accounted for another $29.2M. The decisions to open less stores, payoff long-term debt, and repurchase stock are the main contributors to the negative cash flow. However, due to a higher cash starting point ($40.95M) at the beginning of 2009, the cash at the end of the period is only $1M less than last year at this time.

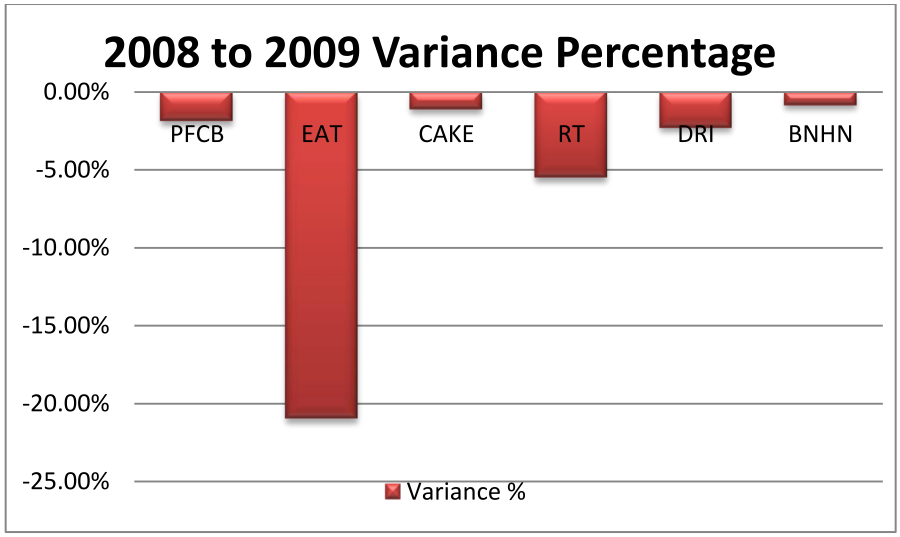
So when looking at the cash flow statement for investment guidance, there are several factors to be considered. Cash from operating activities actually decreased by $1.4M even though net income increased by $8.4M over 2008. There was a decrease in the number of new stores which was offset by the decision to payoff more long-term debt. There was also a repurchase of stock which accounted for the rest of the increase in financing activities. So even though there was a negative cash flow this seems to be fueled by management decisions concerning new stores, debt, and stock.

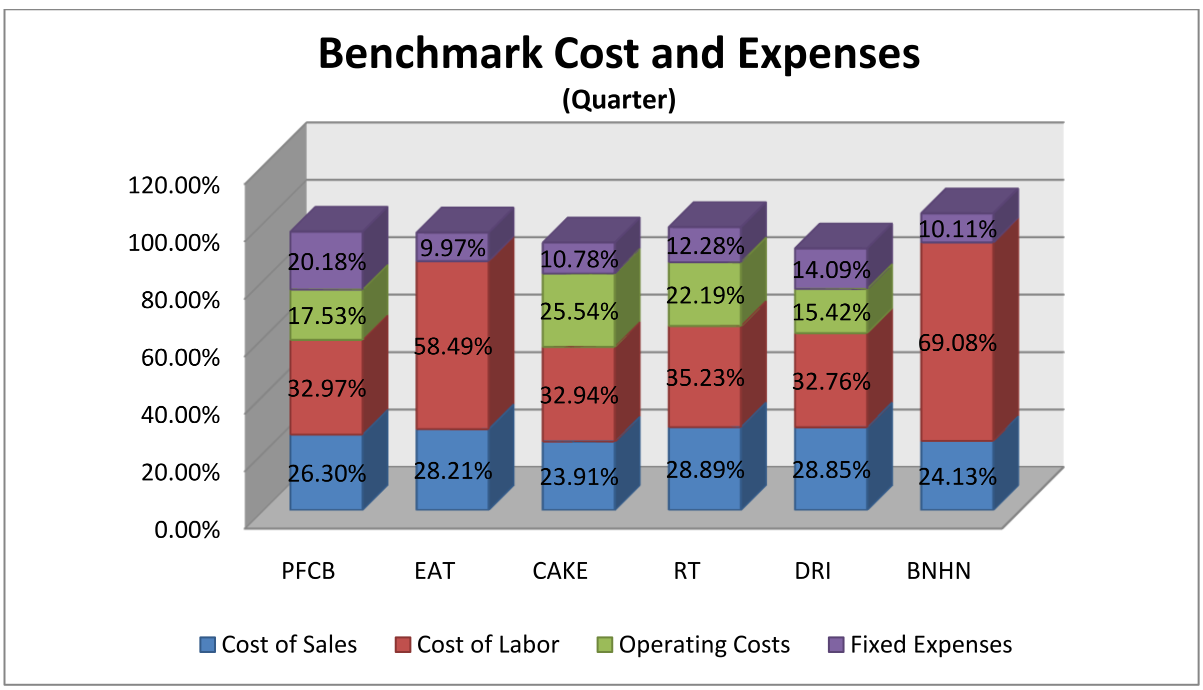
Looking at the management discussion of the financial reports they break down the revenue and costs for P.F. Chang's China Bistro and Pei Wei Asian Diner. Here we see that their flagship Bistro restaurants had a decline of $9.35M (-4.13%) revenue from Q3 2008 to Q4 2009, while the more economical Pei Wei had an increase in revenue of $3.802M (5.48%). The management explains that for same-store revenue, the Bistro actually had a decline of $18.7M (-8.26%) while Pei Wei also had a decline of $0.5M (-0.72%) in same-store revenue. Their discussion was fair and honest and was backed up by the numbers in the financial statements. Their breakout of P.F. Chang's Bistro and Pei Wei operations throughout the discussion was very helpful information from them, as it helped to actually show what was happening for each restaurant concerning revenue and expenses.

For more information we need to look at P.F. Chang's China Bistro, Inc. compared to their competitors. We will look at Brinker International (EAT) who owns Chili's, On the Border, Maggiano's, and Macaroni Grill (which they sold in December 2008 but still holds an 18.2% ownership interest in the new entity). Also, The Cheesecake Factory (CAKE), Ruby Tuesday, Inc (RT), Benihana Inc. (BNHN), and Darden Restaurants Inc

(DRI) who owns Olive Garden, Red Lobster, and several smaller restaurant chains. Since there is a difference in size of each company, we will compare each using percentages and ratios.

Let's first compare the variance percentage in total revenue for each of the companies. In the table we see that all of the companies had a decline in revenue for the latest quarter as compared to the same quarter in 2008. Most of the decline is due to same-store sales decline but are affected by other factors. For instance, PFCB, CAKE, and DRI were able to raise their revenue due to new store openings but all 3 had had a lower (more negative) variance in same-store sales. EAT also had declines in same store sales but they also saw a greater decline due to less traffic from the sale of 189 Macaroni Grill restaurants and 49 restaurant closures. RT also saw their decline lowered due to restaurant closes. Looking at just same-store sales PFCB had the biggest decline (-8.5%), with EAT next at 6.0%, followed by DRI at -5.5%, RT at -3.1%, CAKE at -2.8% and BNHN at -1.0%.





We next need to look how they are handling their costs and expenses. The chart above shows the percentage of costs and expenses as compared to revenue for the last quarter of each of the companies. From the following graph we see that PFCB and DRI are the best at keeping their controllable costs and expenses under control at about 77% of revenue. This results in an efficiency ratio of 0.23 for PFCB and DRI. When compared to last year we can also see that all of the companies, with the exception of EAT and BNHN, were able to reduce their costs and controllable expenses.

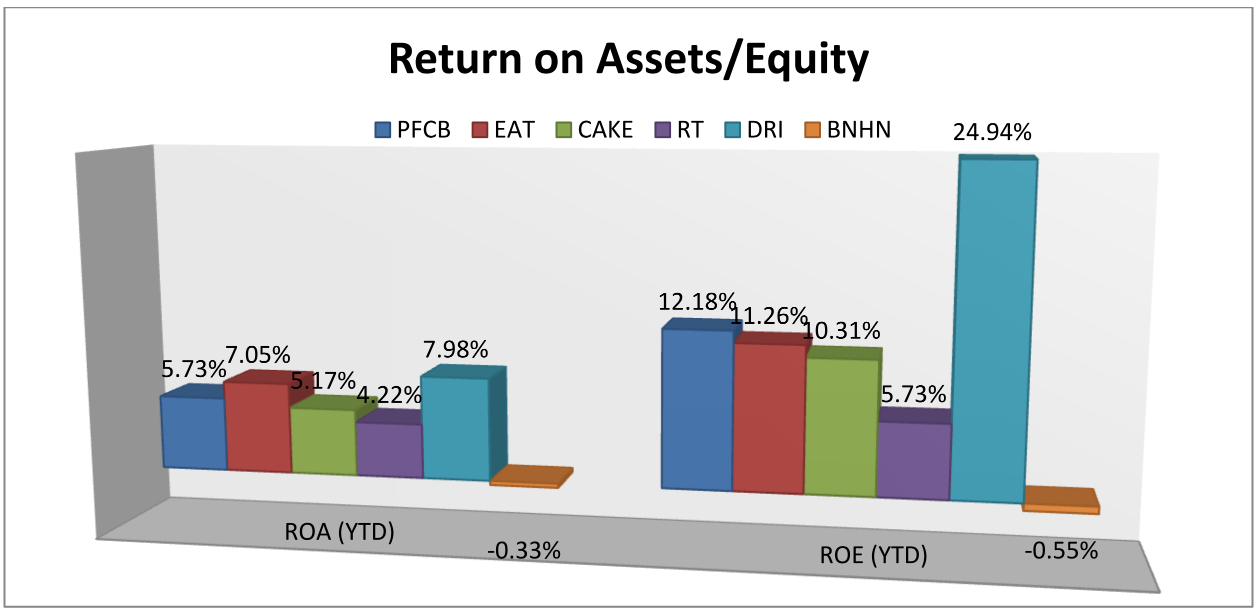
	PFCB	EAT	CAKE	RT	DRI	BNHN
Efficiency Ratio (Q3 2009)	0.23	0.13	0.18	0.14	0.23	0.07
Efficiency Ratio (Q3 2008)	0.22	0.13	0.15	0.13	0.21	0.13

However, PFCB has the highest Fixed Expenses at about 20% of revenue while the others all have fixed expenses from 10%-14%. So overall, PFCB is in the middle of the pack for total expense to sales percentage.

The table below shows the profit and operating margins for each of the companies for the latest quarter as well as for the same quarter in 2008.

	PFCB	EAT	CAKE	RT	DRI	BNHN
Profit Margin (2009)	2.14%	2.03%	4.06%	0.16%	5.44%	-1.58%
Profit Margin (2008)	1.00%	2.42%	2.91%	0.00%	4.63%	2.47%
Operating Margin (2009)	9.58%	8.33%	11.49%	7.98%	13.09%	-2.80%
Operating Margin (2008)	9.53%	8.29%	9.65%	-14.14%	13.09%	4.84%

Only EAT and BNHN had declines in profit margins from 2008 to 2009, while PFCB had an increase from 2008 to 2009 of 1.14%. Their profit margin is the third best of the six companies behind DRI and CAKE. The operating margin shows us the how much a company makes per dollar before taxes and interest and depreciation and amortization. We see that PFCB has increased its operating margin slightly from last year and is again the third best of the six companies behind DRI and CAKE.



The above chart shows us the YTD ROA and ROE of each of the six companies. Professional investors usually look for an ROE of at least 15% and an ROA greater than 5%.[5] We see that only DRI meets both requirements with an ROA of 7.98% and ROE of 24.94%. PFCB has the third best ROA at 5.73% and the second best ROE at 12.18%.

The table below gives some other ratios we can look at to compare these companies.

	PFCB	EAT	CAKE	RT	DRI	BNHN
Acid Test	0.57	0.89	0.89	0.80	0.46	0.46
Current Ratio	0.62	0.98	0.73	0.62	0.26	0.27
Solvency Ratio	2.17	1.52	1.90	1.82	1.50	3.07
Debt/Equity Ratio	0.85	1.94	1.11	1.23	2.00	0.55
Debt/Equity Ratio minus treasury stock	0.61	0.55	0.56	1.23	0.74	0.55

It is no surprise in this economy that none of the companies have acid tests and current ratios greater than one. However they all are solvent with PFCB having the second highest solvency ratio. Only PFCB and BNHN have debt to equity ratios below one. However, if the debt to equity ratio is adjusted for repurchased stock, all of the company's debts to equity ratios drop below one except RT.

Looking at all the numbers compared with its competitors, P.F. Chang's is right around the middle of the pack, doing well in some areas but not as well in other areas, especially in same-store sales revenue. Darden Restaurants, Inc. looks to be the best positioned with its high ROA and ROE ratios and high sales revenue that may give it a little more stability. Benihana's seems to be doing the worst as it has struggled with increased operating expenses along with a decrease in revenue. They are currently operating at a net loss.

Can P.F. Chang's China Bistro Inc. survive this difficult economic period? Like most companies there are some concerns but also some positives. The one major concern is that they have seen a decline year-over-year for Q3 of 8.5% in same-store sales. This number is worse than all its competitors. An even bigger concern is that most of that sales decline is due to their flagship Bistro restaurants which saw an $18.7M decline (or 8.27% decline).

These numbers point to another potential issue and that is the Pei Wei restaurants, which are the economy brand, seem to be doing better than the Bistro restaurants. This may be partially due to the economy, however; what will be the customer reaction as the economy picks up? As customers learn that they can get the same (or similar) food at a lower price, will they continue to patronize Pei Wei in lieu of the Bistro restaurants? In order to bring these customers back to the flagship Bistro restaurant they will need to differentiate themselves from the Pei Wei Asian Diners. For instance, when one looks at the menus for both restaurants they look very similar except for the lower prices at Pei Wei. They need to give both different looks and different items. Also, their Bistro restaurants need to differentiate themselves in service and experience so that the perceived value is higher, which might help attract more customers to the bistros.

Of lesser concern is the fact that the company is well below the level for liquidity as can be seen from the Acid Test and Current Ratio. However, this looks to be the norm for the industry at this time as all of the competitors are in the same boat. Also, their ROA of 12.18% is slightly below the 15% ROA that investors look for when making decisions about investing in a company.

On the positive side, although sales are down, the restaurants have been able to reduce their percentage of costs and controllable operating expenses to total sales. Their efficient ratio is 0.23, tied for the best among its competitors. However, this is partially offset by an increase in general and administrative costs.

Another positive is that they have paid off half of their long term debt in the past year. They have also been on a stock repurchase plan, which seems to be a trend with a lot of restaurants over the past year to year and a half. Their other numbers are pretty solid as well, leading one to think they will be able to survive this difficult time in the economy.

However, I still have concerns about investing in this company. The company is doing a good job putting themselves in a better financial situation, despite the sales decline, by cutting costs, paying off debt, and repurchasing stock. However, there is another issue I believe they may be missing. That issue is there seems to be competition between their two restaurant concepts as the diners are taking market share from the bistros. The bistros account for 75% of revenues for the company, but that is down from 77% in 2008. There is not a lot of differentiation and the smaller, more economical diners may be cannibalizing the higher end bistros which are the company's cash cows. Once they figure this out, it may be a company worth investing in.

Endnotes:

Note: All financial information is from publicly provided SEC filings from Edgars Online and Yahoo Finance unless otherwise End-noted.

---

[1] Corporate Overview, http://phx.corporate-ir.net/phoenix.zhtml?c=62237&p=irol-homeprofile
[2] PFCB Website, "Who We Are: Restaurants", http://www.pfcb.com/restaurants.html
[3] Jeanine Poggi, "Restaurant Rally Ends as Sales Slump", October 22, 2009, http://www.thestreet.com/_yahoo/story/10614836/1/restaurant-rally-ends-as-sales-slump.html?cm_ven=YAHOO&cm_cat=FREE&cm_ite=NA
[4] Phillip Durell, "Using the Debt-to-Equity Ratio", June 20, 2007, http://www.fool.com/investing/value/2007/06/20/using-the-debt-to-equity-ratio.aspx
[5] Ben McClure, "Understanding the Subtleties of ROA vs ROE, http://www.investopedia.com/articles/basics/05/052005.asp