

9 April 1997

## HOW TO ANALYZE A CASE

### A Student Guide

The purpose of this teaching note is to provide the student with hints, clues and suggestions that will help him/her better analyze strategy-oriented case material. The first part of this note contains basic material on case analyses. The second part includes a previously published case which has been annotated in order to illustrate one way in which the material in the case can be used to gain a better understanding of the strategic management process.

#### **What is a case study?**

A case study is best described as a well-orchestrated short story that presents essential information and data on corporate operations. As opposed to, say, a finance or production or marketing case which presents material primarily on one functional area only, a strategic management case takes a holistic view of corporate operations from the perspective of the firm's board of directors and/or its senior executives.

#### **Are there different types of case studies?**

The answer here is "yes"! In general, there are three types of strategy-oriented case studies.

The first type is the problem-oriented case study. In these cases, senior management is faced with a set of circumstances that require it to make a series of strategy-oriented decisions. Sometimes the problem to be solved, or the strategy issue to be resolved is obvious. In other cases, one needs to determine what the problem is before looking for a solution. In both instances, the student-analyst is required to make a number of judgements about the actions to be taken, along with a justification for these actions.

The second type of case study is one which presents overall information on a corporation without, however, presenting a problem or issue that needs to be resolved. As opposed to the problem solving case, these cases are usually designed to give the student a top down view of corporate operations: the businesses that it is in; the markets that it serves; the technologies that it uses; its financial condition; its organizational structure, etc., as a way of providing the student with a senior-level perspective on corporate operations. In these cases, the students-analyst is required to show an understanding of how the corporation is organized, how it operates, and provide some rationale explaining why the corporation operates in the manner set out in the case study.

The third type of case study is one which presents information on the leadership style of the firm's chief executive officer. In these cases, specific information is usually provided on the actions that he may, or already may have taken, to change or otherwise modify the corporate culture; corporate and divisional level organizational changes; and human resource management concepts and

practices. Information on training programs within the company, "employee-empowerment" practices, executive selection procedures are very often part and parcel of this type of leadership-oriented cases. As with the second type of case study described above, the student-analyst is required to show an understanding of the rationale for each of these separate strategic policies and actions, and how these contribute to the overall strength of the corporation.

There may, of course, be other types of strategy case studies but virtually all of them will fall into one of the three categories described above. Some case studies will, of course, contain segments which incorporate information and data relevant to each of the types described above. However, the overall focus of the case study will, in most instances, fall quite distinctly within one of the three categories noted above.

Are there other types of case studies? The answer here is most likely yes. These variations, however, don't show up very often in the literature of the field.

### **Living with the information set out in the case.**

Except as you are required to do some additional research on the company or industry featured in the case study at hand, make every effort to live with the material presented in the case.

A word of explanation is essential here. When presented with a case study, whether it be a strategy, manufacturing, marketing, finance or other type of case, many students try to make judgements on matters for which no information or data has been provided!

The best way to avoid this error is to review what you have written (or the notes that you have made on the case) and ask yourself a very basic question; what information is in the case that supports the judgements or conclusions that I have made? Very often, the answer will be "very little", that is to say, you were being intuitive as opposed to objective in your approach to the project at hand! A good case analysis is an objective one in which you don't reach for solutions or judgements for which there is no basis in the material with which you have to work.

### **Looking for a central issue or problem.**

Study hint! Be patient and read the case through once in its entirety before taking notes and trying to make judgements about the material that is set out in the case. After you have done that, push yourself to come to an understanding of why the author wrote the case and his teaching goal for it. In other words, see if the case fits into one of the three categories noted above. By doing this, you will get a better handle on the case, and be better prepared to discuss the strategy-oriented material set out before you. Asking yourself a series of questions will also help. For example:

- Does the case present a problem or series of problems to be solved?
- Does the case present an overview of the role of the CEO in bringing about change?
- Does the case present a more generalized view of the scope and content of the businesses and markets that the firm is in?

Once you have come a reasonable conclusion here, you can more readily absorb the material in front of you and maximize the learning process that is the basic goal of any case study.

### **General hints, clues and suggestions**

There are a number of methodologies useful in the analysis of strategy-oriented cases that are normally incorporated into strategic management texts. Having read the case through once, make a quick check through your textbook to see if the information at hand fits into one of these conceptual frameworks. For a concise overview of these methodologies, see.....EMK'S previous work for Prentice-Hall. If a methodology fits the facts as they are presented in the case, use it! If nothing else, this will provide you with a convenient and justified way of presenting and analyzing the case's content. As a student, you can't be faulted for using a tried and true methodology.

If the case write-up is problem-oriented, and you are being asked to solve the problem, avoid the "boss is dumb syndrome". Most senior executives know what they are doing, and why they are doing it. More often than not, they choose a reasonable course of action for the company based on the facts (and economic and market conditions) as they then know them. Don't try to second guess them. Rather build on what they have done as a way of enhancing your own background and skills.

If the case write-up is more general in its scope and content, prepare an summary outline of the case using, where relevant, headings such as: leadership style; human resource policies; markets and marketing policies; technological issues; globalization trends; mission statements; etc.. If there is no "problem" to be solved, the best approach here is to do (a) an analysis of the contents of the case while (b) assessing the probable teaching goals for the case assumed by your instructor.

Given all of the above, it is safe to assume that there is no one right answer to a case analysis. At best, there are answers or solutions that are reasonable given the data and information at hand. But they are only reasonable if there is information and data that can be used to back up your conclusions. This means, parenthetically, that you need to do a reality check on yourself and your work from time to time. Compare the facts as presented in the material in the case with your completed analysis. Do the facts support your conclusions? Are you sure?

This latter point leads to a final one. And that is that you can learn a lot from your peers, if only you will discuss their work and yours with them. The reality of most case write-ups is that they contain an awful lot of complex material and data that is not as easily analyzed and understood as one would like. Moreover, any serious analyst brings his own background to the case study. If he is a finance person, he'll look to the numbers first as a way of getting at the required case analysis. If he is a marketing person, he'll look to marketing policies and practices first and probably concentrate on them. Since you are neither expected to, nor can you, in fact, know everything that you would like to know, getting into a work sessions with your peers can be a time-saving way of maximizing the learning process (and your grade). Try to find time for it before you set your final ideas, analyses, and solutions into concrete. Remember here that this is what you will be expected to do once you are in the corporate world. Why not take advantage of the time and freedom that you now have to get an early leg up on the stresses, strains, and benefits of working in a group of interested (and interesting) people.

Professor's Initial Note

*Before starting a review of Ponderosa, Inc., the case study around which this student guide is structured, it is strongly recommended that you read through the case at least once. The purpose of this reading should be to allow you to gain a workable notion of the full breadth and depth of the strategic management issues that are set out in the case itself. Once you have completed the initial review, the annotations made to the case by the author of this note should help you to better understand the strategic management process.*

**PONDEROSA INC.-1988**  
 Fred R. David  
 Francis Marion University

For better or worse, the guard changed at Ponderosa on January 21, 1987, the day Asher B. Edelman completed a hostile takeover. Edelman paid about \$235 million for Ponderosa and Edelman's newly formed company, PON Acquisition Corporation, acquired 95 percent of Ponderosa's outstanding common stock. Edelman replaced Gerald Office as chairman of the board and chief executive officer (CEO). Six members of Ponderosa's board of director resigned and were replaced with Edelman's own directors. Other Ponderosa top managers were fired or resigned on that day, including Thomas Russo, executive vice president; Fred Gonzales, chief marketing officer; and Randy Lawson, chief financial officer. Time alone will tell whether January 21, 1987, was the darkest or the brightest day in Ponderosa's history. Turmoil or prosperity could be on the horizon for Ponderosa, whose headquarters is located in Dayton International Airport in Vandalia, Ohio.

*Professor's note*

*Against the wishes of management, Asher Edelman, a takeover specialist, has managed to purchase 95% of the stock of the Ponderosa Corporation, a chain of specialty restaurants. Two questions need to be set out here:*

- *Is the company worth the \$235 million that Edelman paid for it?*
- *Having bought the business, what does he plan to do with it?*

*Although no evidence about this matter is presented in the case, it is obvious that Edelman spent a substantial amount of time and money analyzing the specialty restaurant business, in general, and Ponderosa, in particular, and then came to three conclusions:*

- *That there is money to be made in the restaurant industry.*
- *That Ponderosa has not been managed to its full potential.*
- *That Edelman and his executive staff can realize the full potential of the company, and earn a respectable profit on their \$235 million dollar investment.*

*From a more general perspective, a good issue to think about as you read the case is the potential differences and similarities between a McDonald's and a Ponderosa-type restaurant. For example: Do they cater to the same group of customers? case. Do they present the same type of logistics and management problems? Can a Ponderosa-type restaurant develop the type of brand name strength of a McDonald's or a Burger King?*

## History

The first Ponderosa steakhouse opened in 1965 in Kokomo, Indiana. In 1969, at the age of twenty-seven, Gerald Office became chairman of the board and president of Ponderosa. During the 1970s, Ponderosa's annual revenues increased every year to a high of \$275 million in 1979 on net earnings of \$13 million. Ponderosa's return on equity was 25.6 percent in 1979 and its debt/equity ratio was 1.46. The 1970s as a great decade for the company.

Ponderosa's fiscal year ends in February. In fiscal 1980 Ponderosa created a wholly owned subsidiary, ESI Meats, to operate a meat-processing and freezer facility in Bristol, Indiana. The Bristol ESI plant is one of the largest freezer facilities under one roof in the world. In addition to supplying all company-owned and most franchised Ponderosa steakhouses with meat products, ESI distributes non-meat items such as French fries, seafood, desserts, and paper products. Fiscal year 1981 was the first disappointing period for Ponderosa. Net income fell to \$2.3 million from \$13.1 million the year before. Return on stockholders' equity fell to 3.5 percent from 20.1 percent in 1980. Four of Ponderosa's top managers resigned or were fired in 1981. New strategies were established in the hope of restoring the company to prosperity.

### Professor's note

*By the time Edelman enters the scene, Ponderosa has been in business for 22 years. In other words, it is a mature company operating in a mature industry with a number of segments, each of which serve a distinct and identifiable market. Through 1980, reflecting a whole series of changes in consumer behavior in the U.S., the company grew substantially earning above average profits of 25.6% on equity at its peak (1979). Since then, its profit on sales and on equity have dropped dramatically making it a potential target for an unfriendly take-over. This is when Edleman came into the picture.*

*As a mind stretcher, you might well ask yourself if the company, as a business entity, is more valuable as a privately-owned company (Edelman, et al) than as a publicly-owned company, and why this may be?*

## Fiscal Year 1982

Ponderosa began concentric diversification in 1982 by acquiring Casa Lupita, a chain of Mexican dinner restaurants that serves a broad range of Mexican and American foods and alcoholic beverages. Although Ponderosa does not have a single executive with experience in running Mexican restaurants, six Casa Lupita restaurants were opened in 1982. Mexican dinner chains enjoyed an average 15 to 20 percent annual growth in 1982.

### Professor's note

*In 1982, the "Mexican style" Casa Lupita restaurants are acquired, and management learns that these restaurants produce a much greater operating profit per customer and per dollar of sales than do the Ponderosa division. Here we need*

*to ask why? What are the characteristics of a Mexican style restaurant? What type of customer does it attract? How do these customers differ from those who frequent the Ponderosa-style restaurant? The answer to these questions has to do both with demographics and Casa Lupita's marketing orientation. However, management does not appear to be applying the "lessons learned" from the Casa Lupita division to the Ponderosa division. Once again, we need to ask why they have not done so. Is it a lack of imagination?. Do the company's two divisions represent different segments of the same industry? What other factors may come into play here. Irrespective of your answer to the above, please remember that corporate sales increase and profits rebound but only to a comfortable but not outstanding 12.5% on equity.*

Casa Lupita restaurants are designed to attract middle- and upper-income customers. They serve a variety of Mexican foods including chimichangas, enchiladas, burritos, tacos, and a wide variety of beef, seafood, and chicken specialties. Customers enjoy complete bar service with margaritas as the featured drink. The decor is classic Mexican and features stucco, Spanish colonial tiles, and live plants. Casa Lupita restaurants have a distinct physical separation between the bar and the dining areas.

Major competitors of Casa Lupita are El Pacho, El Chico, Monterey House, Taco Villa, Taco Plaza, Taco Bueno, Case Ole, Ninfu's, and Chi Chi's. Tacos and tortillas are much less expensive than main courses of beef alone, so Mexican food profit margins are high during economic downturns. Casa Lupita meal tabs average almost double those of a Ponderosa steakhouse. Donald R. Jackson, executive vice president and chief financial officer, said, "Ten Casa Lupitas have the same impact on our bottom line as eighty Ponderosas." Several Casa Lupitas are located in converted Ponderosa steakhouses.

Also in 1982, Ponderosa began to expand internationally. The first international Ponderosa steakhouse restaurant was completed in Watford, England. Watford has a population of about 800,000 and is 12 miles from London. Ponderosa's international market development strategy is targeted toward the United Kingdom, Australia, Germany, Singapore, Malaysia, Indonesia, and Puerto Rico. Ponderosa's net income and return on stockholders' equity rebounded in fiscal 1982 to \$8.3 million and 12.5 percent, respectively.

### **Fiscal Year 1983**

Ponderosa's net income increased further in fiscal 1983 to \$10.4 million on revenues of \$385 million. The company began to emphasize expansion through licensee operations. In this year, Ponderosa opened ten new licensed steakhouses, for a total of 235 licensed steakhouses in the United States and Canada; 447 company-owned steakhouses in the United States and 1 in England; and two company-owned and four licensed Casa Lupita restaurants in the United States. Ponderosa's 682 steakhouses are concentrated in the northeastern United States and Florida; only 17 are located outside these areas.

During 1983, the company cut its debt/equity ratio nearly in half as it made improvements in cost effectiveness and operating efficiency. The company's marketing strategy was changed to

emphasize heavy discounting and television advertising. A new advertising theme was adopted for fiscal 1984: "The Biggest Little Steakhouse in the U.S.A." Ponderosa began shifting its menu mix to higher-priced offerings in 1983.

Professor's note

*Sales growth continues, with a moderate increase in profits from \$8.3 million in 1982 to \$10.3 million in 1983. There are now 682 Ponderosa steakhouses in the United States, of which 447 are company-owned, with the balance licensed. A quick analysis here suggests that profit per unit is some \$14,000 to \$15,000 per year. Although no specific data is given, it would appear that annual sales per company-owned unit are approximately \$800,000 per year (385/447). This may overstate sales somewhat, but it is a reasonable benchmark for later use in the case. More importantly, management appears to be getting its act together after a couple of bad years. One needs to assume here that there has been a senior-level assessment of the firm's strategy with essential changes made to at least some of the elements of this strategy. This is by way of saying that management is "watching the store." This last point should be kept in mind as you review the additional facts and figures presented in this case.*

### **Fiscal Year 1984**

A number of new programs were established in 1984. Ponderosa installed "The World's Biggest, Best Salad Buffet," a striking 30-foot-long buffet of over fifty different items. Also introduced was "The World's Biggest, Best Breakfast Buffet." New marketing programs were instituted to reduce "couponing" and discounting. Total advertising expenditures in fiscal 1984 were approximately 4 percent of revenues, and much heavier emphasis was placed on television media. Ponderosa's featured spokesman in its television ads was President Office. Newspaper advertisements focusing on higher-priced items were planned for fiscal 1985. Ponderosa constructed and opened three new Casa Lupita restaurants and purchased four previously licensed units in the Pacific Northwest. Also during fiscal 1984, Ponderosa began construction of a second restaurant in England and reached a territorial development agreement in the Far East for seven licensed units to be built in Singapore, Malaysia, and Indonesia over the next four years. The strategy of worldwide market development was selected because most restaurant companies operating overseas are of the fast-food variety, not the family steakhouse-type business.

During fiscal 1984, Ponderosa expanded its steakhouse menu to include New York strip steak, filet mignon, porterhouse steak, chicken Italian, country fried steak, and a "Chicken Value Meal." Total revenues and net income increased to \$429 million and \$12.1 million, respectively. By the end of the year there were 436 company-owned Ponderosa steakhouses in the United States plus 1 in England, 221 licensed steakhouses in the United States and Canada, and 9 company-owned Casa Lupita restaurants in the United States.

Professor's note

*As suggested above, basic changes were made in the corporation's strategy, specifically changes to Ponderosa's product line. As a result of this, profit and sales increase steadily, albeit not dramatically. As a separate issue, the company starts the "globalization" process but only in a minimal way. Is this a good move? Why? Would the company be better off concentrating solely on the domestic market? Again, why? Stretch a bit and ask yourself whether going global may or may not be a management frivolity; a way of exercising personal as opposed to business choices?*

### **Fiscal Year 1985**

During fiscal 1985, Ponderosa constructed eleven new Casa Lupita restaurants in New Jersey, Florida, Pennsylvania, Ohio, Michigan, and Illinois. Total revenues for fiscal 1985 increased to \$513 million, but net income decreased to \$8.4 million. Return on stockholders' equity for 1985 was 6 percent, and the debt/equity ratio was 0.30.

Ponderosa designed and tested a steakhouse renovation program during fiscal 1985. This renovation included lighter color schemes, new small wares, uniforms, more efficient layouts, and additional seating. The company also decentralized marketing decision making to allow individual districts and restaurants to respond more quickly to local competitive pressure and customer preference.

Some of Ponderosa's critics said that the company should have been pursuing domestic market development rather than foreign market expansion, since there were still only two Ponderosa steakhouses in the southern United States (excluding Florida), no restaurants on the West Coast, only seven restaurants west of Texas, just one Ponderosa steakhouse in Texas, and no Ponderosa restaurants in California or the Carolinas. Critics asked, "Why is Ponderosa interested in putting restaurants in Malaysia, Singapore, and Indonesia instead of North Carolina, Louisiana, California, and other states with no Ponderosas?"

The Watford restaurant was enjoying exceptional success. Although its storefront location limited its seating capacity, customer counts were 50 percent larger than those recorded in the average American Ponderosa. A second Ponderosa steakhouse opened in Croydon (London) early in fiscal 1985. Ponderosa's long-term strategy in 1985 was to find joint-venture partners who would develop the Ponderosa concept internationally. Ponderosa estimated that as many as 100 of their steakhouses could operate successfully in Great Britain alone.

By the end of fiscal 1985, Ponderosa was offering a breakfast buffet in over 400 company-owned steakhouses and 90 licensed restaurants and produced over \$60 million worth of new business. During the second quarter of fiscal 1985, prices for the all-you-can-eat breakfast buffet increased from \$2.99 to \$3.19 on weekdays and from \$3.59 to \$3.79 on weekends.

Professor's note

*1985. Sales up. Profits down. Casa Lupita division is expanded. Ponderosa stores renovated. Company expands on its globalization policy despite the firm's critics questioning the move. The suggestion here is that the domestic market has not been fully exploited and that the globalization effort diverts management attention and resources away from the firm's basic business. Although there is no way of answering the question, as suggested in an earlier comment, one needs to ask "why" here.*

*Once again, you can stretch a bit and ask yourself why going global was (and is!) a good policy for the likes of Pepsi-Cola, Coca-Cola, McDonald's, and others, but not potentially for a Ponderosa. What, if any, are the key differences here between the listed companies and Ponderosa? Can Ponderosa ever be in their class?*

**Fiscal Year 1986**

In 1986, net income again declined by 55 percent to \$3.7 million. Revenues in fiscal 1986 also decreased to \$490 million. Earnings per share declined to \$0.39 in 1986 compared to \$0.92 in 1985, a 58 percent decline. These declines weakened Ponderosa. The company was further weakened in fiscal 1986 by having to defend itself from a hostile takeover by USA Cafes, the parent company of Bonanza steakhouses. The successful defense cost Ponderosa \$2.6 million in investment banking and legal fees.

Professor's note

*1986. Sales and profits down. Since no reason for the decline in both sales and profits is given, one cannot make any appropriate judgement here. However, one could hazard the guess that Ponderosa's senior management's attention was diverted away from the day-to-day management of the firm because of their need to defend the firm against the first of the hostile takeover efforts that it will have to endure. Notwithstanding this effort, moderate changes are made to product line. More critically, the strategic emphasis switches away from opening more company-owned restaurants to a franchise-oriented, strategy. Before leaving this issue, a bit of brain-storming as to the advantages and/or disadvantages accruing to a greater emphasis on franchised operations would be advantageous. What are the pluses and minuses of a heavy reliance on franchise operations? Although the case contains no details on this issue, it appears more than evident that the firm's senior management has established a new strategy for the firm; that is, to use franchising as the basis for the further growth of the Ponderosa division.*

*Although there is no specific information provided with respect to an additional policy-level decision, it now appears obvious that the firm plans to gradually switch its investments away from the Ponderosa division in order to concentrate on the more profitable Casa Lupita division.*

*In all, given the evidence in the case, this appears to be a reasonable and intelligent approach business-wise.*

A number of new products were introduced in fiscal 1986, including the "No Stopping the Topping Sundae Bar" and a hot vegetable bar called the "Hot Spot." However, breakfast was removed from 260 company-owned steakhouses due to unsatisfactory profit levels (178 company-owned and franchised steakhouses continued to serve breakfast). Thirty new steakhouses were franchised during fiscal 1986, and thirty-five company-owned restaurants were sold to franchises. Three new Casa Lupita restaurants were opened in fiscal 1986. The fourth Ponderosa in England opened in fiscal 1986. Franchised Steak & Salad Restaurants opened in Singapore, Taiwan, and the Republic of China.

During the fiscal 1986, the corporate staff was cut by two-thirds, with expected savings of \$3.5 million a year starting in 1987. Plans for fiscal 1987 were to open sixty-seven new franchised steakhouses and two new Casa Lupita restaurants, to build twenty new company-owned steakhouse restaurants, to franchise eight new Steak & Salad Restaurants overseas, and to remodel seventy steakhouses. Ponderosa's long-term strategy was to have 500 franchised steakhouses by fiscal 1991.

### **The Takeover Years**

Then it happened. On December 2, 1986, the PON Acquisition Corporation made an unsolicited tender offer to purchase all outstanding shares of common stock of Ponderosa. On January 21, 1987, PON Acquisition obtained 7.7 million shares of Ponderosa's common stock. In exchange, Ponderosa stockholders received \$29.25 per share in cash, amounting to \$15,100,000. These shares, together with the 1.6 million that PON already owned, constituted approximately 95 percent of the shares outstanding. On the same date, Office resigned under pressure as CEO and chairman of the board of Ponderosa. For fiscal year 1987, Office received a salary of \$610,577, plus \$6,378,133 pursuant to the "change of control" provisions, \$1,731,358 for stock appreciation rights, and \$48,619 in additional compensation. Due to a so-called "golden parachute" feature in his contract, he will receive from Ponderosa an annual salary of \$500,000 through 1998.

Frank Holdraker (age forty-three) now serves as president and CEO of Ponderosa. David Pertl (age thirty-five) is chairman of the board of directors. Current directors include Gerald Agranoff, Jamie Coulter, Frank Holdraker, Corey Horowitz, and Gerald Office. Office's resignation as a director of Ponderosa was effective on December 31, 1987. Exhibit 1 illustrates Ponderosa's organization immediately following the takeover.

### *Professor's note*

*Edelman strikes! Other than the price which Edleman pays for the publicly-held stock, no information is provided on Edelman's long-term financial strategy. Did he use equity money for the transaction? Did he use debt funds as what would then be a first step in the debt-oriented recapitalization of the firm? It would be nice to have information on these matters since it would provide important signals on the*

*business strategies that Edelman intends to pursue once he is in command. However, since no data is provided no judgements can be made here.*

*Of general interest here are the amazingly high costs associated with the takeover, especially those attributable to "golden parachutes" for Ponderosa's old management team. It seems safe to assume here that they knew that they would be subject to additional hostile take-over bids, and were in fact prepared for this eventuality. One can again stretch his/her mind by asking why the old management team did not pursue anti-takeover strategies other than that of the "golden parachute" type.*

As a result of the acquisition, Ponderosa reported two financial statements in its 1987 Annual Report; one was for the weeks ending January 21, 1987, and the other was for the five weeks ending February 26, 1987. For the forty-seven weeks ending January 21, Ponderosa's revenues declined further to \$480 million, and net income declined to \$2.1 million from fiscal 1986. For the five weeks ending February 26, 1987, revenues were \$54 million, and net income was a negative \$3.9 million. Ponderosa's debt/equity ratio jumped from 0.45 on January 21, 1987, to 8.54 on February 26 due to takeover debts. Ponderosa incurred \$19.5 million in debt due to the takeover, including \$8.682 million for severance payments to executive officers, \$5.452 million for investment banking and legal fees, \$5.108 million for payment of stock appreciation rights, and \$226,000 for other expenses. A summary of the purchase price and allocation of purchase price is given in Exhibit 2.

*Professor's note*

*The data in the case on Ponderosa's debt/equity ratio appears to be in error. A review of the data set out in Exhibit 4 does not confirm this calculation. The approximate \$36 million reported as "current portion of long term debt due" in 1987 is inconsistent with the data published for the 1986 fiscal year. However, for our purposes here, this figure can be accepted as correct and its importance, if any, discussed at a later time. Of more importance financially, is the \$19.5 million in fees and severance payments that were incurred by Ponderosa as the result of the take over of the firm by the Edelman group. Although not directly related to the focus of this case, the financial data related to the take-over effort itself could be a strategy case unto itself.*

### **Ponderosa's Internal Operations**

Ponderosa obtained a \$40 million revolving credit agreement among five banks during fiscal 1987; \$20.5 million of that money was still available on February 26, 1987. However, Ponderosa is now in violation of certain loan covenants of this agreement. Ponderosa's income statements for fiscal 1985, 1986, and 1987 are provided in Exhibit 3. The company's balance sheets for fiscal 1986 and 1987 are provided in Exhibit 4. Ponderosa's statement of changes in consolidated financial position for fiscal 1985, 1986, and 1987 is given in Exhibit 5.

Edelman is changing Ponderosa's organizational culture. He has changed Ponderosa's logo from a globe to a pine tree, as illustrated in Exhibit 6. The green pine tree symbol appeared on the front cover of Ponderosa's 1987 Annual Report for the first time. Previous annual reports featured the globe symbol. Edelman explains the logo change in the company's 1987 Annual Report (from the inside front cover):

"The new Ponderosa logo reflects the contemporary needs of our customers. Customers identify the Company with the Ponderosa pine trees and the use of green, beige, and burgundy was found to have a wider appeal. The positive image conveyed by the new logo has resulted in the Company utilizing the new logo and its color scheme in the remodeling program, new signage, employee uniforms, and a variety of in-unit supplies. The continued and extensive usage of the logo is expected to reinforce positive recall of Ponderosa and the pleasant dining experience which it affords."

Ponderosa's advertising spending increased from \$19.3 million in fiscal 1986 to \$22.0 million in 1987. Fees received from franchises increased to \$7.9 million in 1987 from \$6.7 million in 1986 and \$5.6 million in 1985.

*Professor's note*

*Nothing overly significant here. New organization brought in to manage the firm. Some moderate changes to the "corporate culture". Franchising fees increased consistent with the policies of the previous management team.*

*Exhibit 1 Ponderosa's organizational chart in fiscal 1986.*

Asher B. Edelman, Chairman of the Board

Frank J. Holdraker, President and Chief Executive Officer

D. E. Pertl, Senior VP, Chief Financial Officer, and Treasurer

J. R. Mohr, Senior VP, General Counsel and Secretary

P. A. Roelofs, Senior VP, Operations

T. F. McCarthy, Senior VP, Marketing

D. S. Wayne, VP, Internal Audit

W. K. White, VP, Financial Planning

J. J. Rieger, VP, Controller

J.D. Seaton, VP, Regional Manger

K.J. Regan, VP, Regional Manager

A. R. Brinkman, VP and General Manager, ESI Meats, Inc.

E. J. Brolick, VP, Restaurant Services and Development, Casa Lupita Restaurants

R. J. Hayes, VP, Procurement and Quality Assurance

R. V. Mare, VP, Licensing and Unit Development

J. M. Osborne, VP, Human Resources

J. N. Theoharis, VP, Operations, Casa Lupita Restaurants

R. J. Hoffman, VP, Concept and Product Development

J. Lac, VP, Marketing

M.J. Lawless, VP, Planning and Market Research

*Source: Based on information given in Ponderosa's 1987 Annual Report, p. 42.*

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**Exhibit 2 Summary information regarding the purchase price of Ponderosa (in thousands of dollars)**

Purchase Price

The purchase price consists of the following:

Cost to acquire 9,344,621 shares:

Capital contribution (1,603,300 shares)	\$ 38,617
Acquired in tender offer (7,741,321 shares)	226,433

Total:	265,050
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Remaining common shares including redemption of outstanding options (519,810 shares)

	15,100
Fees and expenses	9,597
Total Purchase Price	\$289,747

Allocation of Purchase Price

The allocation of the purchase price is as follows:

Cash	\$12,862
Accounts and notes receivable	4,589
Inventories	5,719
Assets held for sale	54,300
Property, plant, and equipment	188,371
Other assets	36,336
Accounts payable	(28,650)
Accrued expenses	(36,010)
Long-term obligations (including current portion)	(56,937)
Excess of cost over fair value of net assets acquired	109,167
Total Allocation of Purchase Price	\$289,747

Source: Ponderosa, Inc., Annual Report, 1987, p. 31. Used with permission.

Professor's note, Exhibit 2

*From a financial accounting perspective, nothing unusual here.*

Exhibit 3

Ponderosa's statement of consolidated income (in thousands of dollars except per-share data)

	47 Weeks, Year Ended		
	February 28, 1988	January 21, 1987	February 27, 1986
Revenues			
Food sales	\$461,363	\$474,109	\$499,411
Service fees & other income	18,915	16,195	13,891
Total Revenues	480,278	490,304	513,302
Cost and Expenses			
Cost of food sales	191,544	195,045	219,281
Restaurant operating expenses	233,382	255,457	247,532
Rent expense	16,952	19,094	18,089
General & admin expenses	7,606	7,115	9,715
Interest expense	5,040	6,435	6,678
Takeover expenses	19,468	2,558	--
Total Cost and Expenses	473,992	485,704	501,295
Income Before Income Taxes	6,286	4,600	12,007
Income Taxes			
State, local and foreign	1,058	818	1,228
Federal Current	2,291	43	705
Deferred	844	(\$8)	1,670
Total Income Taxes	4,193	853	3,603
Net Income	2,093	3,747	8,404
Net Income Per Share	\$0.21	\$0.39	\$0.92
Average Shares Outstanding	9,752	9,680	9,161

Source: Ponderosa, Inc., Annual Report, 1987, p. 12. Used with permission.

Professor's note, Exhibit 3.

*The figures here are most revealing. As noted earlier, the takeover expenses for the 47 weeks ended January 21, 1987, are reported as \$19,648,000! Had this cost not been incurred, the reported income before income taxes for this period would have been a record \$25,754,000, an amazing increase over the similar figures reported for 1985 and 1986. The most logical conclusion to be drawn here is that the strategic initiatives put in place by the firm's old management were successful....and that Edelman's purchase price of \$235,000,000 is justified based on the rapid turn-*

*around in corporate efficiency that these figures reveal. Confirming evidence of this turn-around is presented in the remaining sections of this case.*

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Exhibit 4

Ponderosa's consolidated balance sheets (in thousands of dollars)		
	January 21, 1987	February 27, 1986
Assets		
Current Assets		
Cash and short-term investments	\$14,368	\$11,804
Accounts and notes receivable	7,481	7,146
Recoverable federal income taxes	1,021	133
Inventories	20,463	16,804
Prepaid expenses	6,628	4,703
Total current assets	49,961	40,590
Property, Plant, and Equipment		
Land and improvements	17,809	15,550
Buildings, leaseholds, and improvements	155,847	146,395
Equipment	169,462	163,857
Construction in progress	15,786	2,248
Total property, plant, and equipment	358,904	328,050
Less accumulated depreciation and amortization	(144,188)	(135,225)
Net property, plant, and equipment	214,716	192,825
Other Assets	23,177	22,058
Total Assets	\$287,854	\$255,473
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	\$29,256	\$25,369
Accrued payroll and employee benefits	9,493	7,705
Accrued interest	675	590
Accrued insurance	4,245	3,271
Accrued expenses	16,840	8,634
Federal taxes payable	145	
Current portion of long-term obligations	35,969	3,860
Total current liabilities	96,623	49,429
Notes Payable	5,698	22,917
Obligations under Capitalized Leases	24,828	25,454
Deferred Federal Income Taxes	14,032	12,392
Stockholders' Equity		
Preferred stock, no par value authorized 25,000,000 shares (none issued)	--	--
Common stock, par value \$0.10 per share authorized 25,000,000 shares (issued 1987--10,444,147; 1986--10,403,211)	1,044	1,040

Additional paid-in capital	64,753	62,510
Retained earnings	85,959	87,313
Foreign currency translation	(623)	(688)
Less cost of shares in treasury (shares in 1987--644,711; 1986--707,711)	(4,460)	(4,894)
Total stockholders' equity	146,673	145,281
Total Liabilities and Stockholders' Equity	\$287,854	\$255,473

Source: Ponderosa, Inc., Annual Report, 1987, pp. 12, 14, 15. Used with permission.

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### Ponderosa Steakhouse Division

As of April 1987, Ponderosa operated 407 steakhouses and franchised another 246 restaurants using the name "Ponderosa Steakhouse." The company had steakhouses in thirty-one states, the Virgin Islands, Puerto Rico, and Canada. Ponderosa also operates three restaurants and franchises five others under the name "Ponderosa Steak & Salad" in Singapore, England, the Republic of China, and Taiwan. In fiscal 1987 forty-nine new steakhouses were opened. Of these, forty-three were franchised and six were company-owned. Three steakhouses were franchised in international markets. Average customer counts per week in fiscal 1987 increased 14.4 percent from the previous fiscal year.

#### Professor's note

*A question here! Why are franchisees not required to purchase meat and other supplies through ESI Meats? This is somewhat inconsistent with the policies instituted by firms such as McDonald's, Burger King, etc. information in the case as to the strategic imperatives here. But it is a very important question.*

*Approximately 90 million meals were served to Ponderosa customers during fiscal 1987. Average weekly sales for lunch and dinner increased 17.6 percent from \$16,784 in 1986 to \$19,739 in 1987. Ponderosa attributes this growth to the following factors:*

- The remodeling of 117 steakhouses;
- The new marketing theme "There's a Family Feeling at Ponderosa";
- The dedication to quality, service, and cleanliness;
- Several new menu items, including seafood products and charbroiled chicken.

*Ponderosa maintains tight control over its licensed steakhouses by requiring licensee managers to complete the company's formal training program and to operate their restaurants the same way as the company-operated steakhouses. However, license agreements do not require licensees to purchase any meat or supplies from ESI Meats, nor do they require a set of regulated prices. Ponderosa retains the right to inspect franchise steakhouses and cancel licenses if company*

*standards are not met. Exhibit 7 presents statistics that describe Ponderosa's Steakhouse Division for fiscal years 1984 through 1987.*

*A Ponderosa steakhouse is generally staffed by fifty hourly employees and three managers. Each steakhouse has about 5,400 square feet, with seating capacity for 200 customers and parking available for 100 automobiles. Ponderosa is remodeling the interior and exterior of its restaurants, including new signs, lighting, carpeting, furniture, and changes to the facade. In certain restaurants, windows are being added to create a more airy, open environment. As of February 1987, 117 steakhouses had been remodeled. The company plans to remodel seventy more in fiscal 1988. In addition, sixteen franchised restaurants have been remodeled, and it is expected that twenty to twenty-five more will be remodeled by the end of 1988. Ponderosa encourages franchisees to remodel in accordance with approved plans by offering credit with a maximum of 10 percent of the remodeling costs.*

#### Exhibit 5

Ponderosa's statement of changes in consolidated financial position (in thousands of dollars)

	47 Weeks Ended		Year Ended
	January 21, 1987	February 27, 1986	February 28, 1985
<b>Cash Provided from Operations</b>			
Net income	\$2,093	\$3,747	\$8,404
Noncash charges to net income			
Depreciation	21,433	22,920	21,015
Amortization	3,970	3,900	3,751
Deferred income taxes	1,640	782	1,857
<b>Changes in working capital components</b>			
Accounts and notes receivable	(335)	(1,032)	(876)
Federal income taxes	(888)	2,275	(745)
Inventories	(3,659)	271	(229)
Prepaid expenses	(1,925)	(757)	(847)
Accounts payable and accrued expenses	15,085	(1,633)	5,990
Cash Provided from Operations	37,414	30,473	38,320
Dividends paid or payable	(2,928)	(3,876)	(3,845)
Cash Provided Before Investing and Financing Activities	34,486	26,597	34,475
Investing Activities			
Additions to property, plant and equipment	(57,174)	(25,815)	(50,812)

Carrying value of property, plant, & equipment disposals	13,850	2,245	3,197
Resources designated for construction and acquisitions	--	--	7,053
Other, net	(5,559)	(5,016)	(5,599)
<b>Cash Used by Investing Activities</b>	<b>(48,883)</b>	<b>(28,586)</b>	<b>(46,161)</b>
<b>Financing Activities</b>			
Proceeds from notes payable and capitalized lease obligations	22,171	21,146	2,719
Repayment of notes payable and capitalized lease obligations	(7,956)	(12,408)	(26,201)
Proceeds from stock issuance	--	--	30,023
ESOP and Retirement Savings Plan contributions and exercise of stock options	2,681	873	627
Foreign currency translation	65	295	(580)
<b>Cash Provided from Financing Activities</b>	<b>16,961</b>	<b>9,906</b>	<b>6,588</b>
<b>Increase (Decrease) in Cash and Short-term Investments</b>	<b>2,564</b>	<b>7,917</b>	<b>(5,098)</b>
<b>Cash and Short-Term Investments, Beginning-of-period</b>	<b>11,804</b>	<b>3,887</b>	<b>8,985</b>
<b>Cash and Short-Term Investments, End-of-period</b>	<b>\$14,368</b>	<b>\$11,804</b>	<b>\$3,887</b>

*Source: Ponderosa, Inc., Annual Report, 1987. Used with permission.*

*Professor's note*

*Good information here and no surprises since the financial data are directly related to the strategic initiatives undertaken by the now deposed management team.*

### **Casa Lupita Restaurants**

Casa Lupita restaurants offer a complete line of Mexican foods, as well as alcoholic and nonalcoholic beverages in a festive atmosphere featuring stucco, Spanish colonial tiles, and Mexican decor. Once recruited, Casa Lupita franchise licensees undergo a four-month training program that includes both classroom and hands-on experience. Casa Lupita restaurants generally have 100 hourly employees and 5 managers. The restaurants range in size from 5,000 to 11,400 square feet, with seating for 100 to 270 customers in the dining area and about 75 in the bar. Casa Lupita operates twenty-three restaurants and franchises three others in the United States. Casa

Lupita's average sales per week increased to \$36,718 in 1987, up 5.3 percent from the previous year. The average check per person was \$9.92. Two new franchised Casa Lupita restaurants and two company-owned restaurants were opened in 1987. Food sales for company-owned Casa Lupita in fiscal 1987, 1986, and 1985 were \$39.3 million, \$34.2 million, and \$23.9 million, respectively.

Casa Lupita has restaurant franchise and exclusive area development agreements. The area development agreement calls for the franchise to pay a start-up fee of \$10,000 per restaurant. Casa Lupita's franchise requirements are generally the same as those for the Ponderosa Steakhouses. As of April 1987, the company had three area development agreements in which ten restaurants would be opened by 1992. Because of uncertainty surrounding the planned divestiture of Casa Lupita, Ponderosa has given indefinite extensions to the development schedules. Exhibit 8 summarizes the location of all Ponderosa Steakhouse and Casa Lupita restaurants as of April 30, 1987.

*Professor's note*

*Same as our earlier comment in that there are no surprises here. Indeed, the data do no more than confirm the effectiveness of the plans for this division put in place by the now deposed management team. Again, Edelman must have had prior knowledge of this outcome with his valuation of Ponderosa based, in part, on this projected outcome.*

**ESI Meats, Inc.**

ESI sales for 1985, 1986, and 1987 to company-owned restaurants were \$76,960,000, \$72,472,000, and \$96,305,000 respectively. Sales to franchisees and others were \$24,966,000, \$27,391,000, and \$45,218,000 during these years. The company is currently planning to divest itself of ESI, but if the divestiture occurs, ESI will still be required to supply Ponderosa and its franchisees. Ponderosa's cost of food sales as a percentage of total foods sales increased to 41.5 percent in fiscal 1987 from 41.1 percent in fiscal 1986, largely due to the increase in ESI sales. Food received from ESI has a higher percentage cost of sales.

*Professor's note*

*One can only conjecture here that ESI is profitable and that a sale to a "related person" will be undertaken here in order to increase Ponderosa's overall liquidity, simplify Ponderosa's management procedures, and, given the size and sophistication of the ESI operation, provide the "related person" with an opportunity to expand both sales and profits. Since no additional data is provided in the case, no further comments can be made.*

**Employee Benefits**

There were approximately 24,300 Ponderosa employees as of April 30, 1987. About 70 percent of them were employed for thirty hours of less per week.. Casa Lupita employed about 2,500 persons and ESI about 500. There is no union at any Ponderosa facilities.

Ponderosa offers employees aged twenty-one and over who have completed one year of service a retirement savings plan. This plan allows employees to contribute up to 10 percent of their annual compensation before taxes and an additional 6 percent of their compensation after taxes to a variety of investment alternatives. Ponderosa matches 50 percent of each participant's allocation up to 2 percent of each participant's annual compensation. For fiscal 1987, 1986, and 1985, Ponderosa contributed \$624,000, \$733,000, and \$618,000, respectively, to the retirement savings plan.

Ponderosa also offers a company pension plan for employees aged twenty-one or over who have completed one year of service. Ponderosa contributed \$270,000, \$395,000, and \$382,000 for 1987, 1986, and 1985, respectively, to the employee pension plan.

### **Environmental Factors**

The cost of beef significantly affects Ponderosa's cost of food. As the price of beef goes up, Ponderosa's costs increase. The nationwide shift away from red meat to poultry and fish represents a threat to Ponderosa. However, the American beef industry spent \$44 million in 1987 to promote "The Lighter Side of Beef." A recent advertisement saying "Beef, Real Food for Real People" had Cybill Shepherd wondering whether she could trust someone who doesn't eat hamburgers. In another advertisement, James Garner offered his beef kabob recipe: just sirloin, no vegetables.

Public opinion polls clearly show a growing concern among the general public about residues from pesticides, herbicides, and other agricultural chemicals in restaurant foods. As a result, more and more patrons of national steakhouse chains, as well as of other restaurants, are eating out less, buying fresh food from supermarkets, or even growing their own food.

The Tax Reform Act of 1986 directly affects Ponderosa, too. The reduction in the corporate tax rate from 46 to 40 percent in 1987 and to 34 percent in 1988 represents an opportunity. However, the Tax Reform Act also provides retroactive elimination of the investment tax credit for property placed in service after December 31, 1985. This is a threat to Ponderosa because historically the investment tax credit was an important factor in reducing the company's effective tax rate. Depreciation schedules have been extended from three years to five years on much equipment that Ponderosa uses, including automobiles and trucks. Other legislative threats facing the restaurant industry, including Ponderosa, require employers to pay social security taxes on all employees tips, to pay minimum health care benefits to all employees, to grant up to eighteen weeks of unpaid parental leave every two years and twenty-six weeks of unpaid disability a year, and to give advance notice of a mass layoff or business shutdown.

Ponderosa's business is seasonal, and summer months normally generate higher average weekly sales than winter months. This is especially true in the northeastern and mid-western United States during harsh winters. In September 1987 the United States Department of Commerce forecast that disposable personal income would increase 2 percent in 1988, compared to 1.4 percent in 1987. The Commerce Department also forecast that employment rates would rise 1.6 percent in 1988 compared to 1.2 percent in 1987.

According to the 1987 Gallup Annual Report in Eating Out, 33 percent of all breakfast and dinner customers and 26 percent of all lunch customers are aged fifty or older. Older Americans still eat out less than younger adults, but the gap is narrowing. On a typical day, 36 percent of all adults eat out. Dining out increased by 6 percent between 1978 and 1986, but for the fifty-and-older group it increased 21 percent. Where these people decide to eat is the important question for top managers of major restaurant chains such as Ponderosa. For example, older people are more than twice as likely to order seafood as individuals aged eighteen to forty-nine. However, older individuals are less than half as likely to purchase take-out food or want an extensive menu or wine list.

Professor's note

*The information on both Employee Benefits and Environmental Factors is best viewed from the perspective of a SWOT...strengths, weaknesses, opportunities and threat...analysis. For example:*

*The decrease in corporate tax rates mandated by the Tax Reform Act of 1986 will do lots to improve Ponderosa's bottom line! The loss of the Investment Tax Credit may be a negative here but, if Ponderosa pursues the franchising policy, this loss will be more critical to its franchisees than to the parent company.*

*Conversely, all firms in the restaurant industry will be affected by the labor law changes suggested in the text. Obviously, these cost increases will have to be passed on to the industry's customers if the industry is to remain viable. At issue here is the price sensitivity of the customer base served by Ponderosa and other firms in the low-cost, fast-food segment of the industry. Note, however, the age distribution of the customers served by the industry. The group aged 50 or over can more easily absorb a price increase because they are beyond the child-rearing age...and because they may place more emphasis on leisure than does the younger consumer.*

*The data in Exhibit 7 seems consistent with this conclusion. Weekly sales per restaurant are up. The average check amount is up! And, most important of all, the weekly customer count is up!*

*Exhibit 8 is an extremely important document with its importance discussed later in this teaching note. See page.....*

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Exhibit 7

Ponderosa's Steakhouse Division, 1984--1987

	1987	1986	1985	1984
Average weekly sales per restaurant	\$20,406	\$18,267	\$19,376	\$16,487
Average weekly customer count	4,302	4,003	4,284	3,999
Average check amount	4.74	4.56	4.52	4.12

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**Exhibit 8****The locations of Ponderosa steakhouses and Casa Lupita restaurants on April 30, 1987**

	Steakhouses		Casa Lupitas		TOTAL
	Company	Franchised	Company	Franchised	
Restaurants					
Arizona		2			2
California		2			2
Colorado		2			2
Connecticut	8	1			9
Delaware		1			1
Florida	28	19	6	2	55
Georgia	1	1			2
Illinois	44	7	1		52
Indiana	21	42			63
Iowa	4				4
Kansas	4				4
Kentucky	9	9			18
Massachusetts	6	3			9
Michigan	30	27	2		59
Minnesota	9	1			10
Missouri	19	3			22
New Hampshire		1			1
New Jersey	1	14	2		17
New York	51	11			62
North Carolina		1			1
North Dakota		2			2
Ohio	104	14	5		123
Oregon			1		1
Pennsylvania	27	34	1	1	63
Rhode Island	3	1	1		5
South Carolina		1			1
Utah		6			6
Vermont		2			2
Virginia		6			6
Washington		1	4		5
West Virginia	8	1			9
Wisconsin	30	4			34
U.S. Total	407	219	23	3	652
Puerto Rico		7			7
U.S. Virgin Islands		1			1
Canada		19			19
U.K.	3	1			4
Singapore		2			2
Taiwan, Rep. Of China		2			2
Total Restaurants	410	251	23	3	687

Source: Ponderosa, Inc., Annual Report, 1987, p. 43. Used with permission.

The Commerce Department reported in June 1987 that sales trends at the nation's restaurants had slowed for the fourth consecutive month. Total revenues at restaurants and bars in the United States were \$13.21 billion in June 1987. This was 5.3 percent higher than in June 1986 but lower than the percentage increase in May. As interest rates rise and disposable income decreases, restaurant meals are one of the easiest cuts in household budgets.

Lobbying groups such as the National Restaurant Association and the Foodservice and Lodging Institute work hard in Washington, D.C., to head off legislation that could hurt the restaurant business. Most of Ponderosa's employees are paid hourly rates as determined by federal and state minimum wage and tip credit laws. Consequently, the current minimum wage rate of \$4.65 an hour represents a threat to the restaurant industry. Other proposed legislation on tip reporting and tax reform would limit deductions for business meals.

### **Competition**

Supermarkets are beginning to challenge restaurants by offering freshly prepared foods; delis and salad bars are becoming common in these nontraditional settings. For example, Food Emporium and Shopwell, both divisions of the A & P Company, recently began offering a line of seven freshly prepared appetizers and salads and ten entrees daily. The supermarket challenge to restaurants is spreading rapidly from the New England states, Ponderosa's primary market area. Prepared ready-to-eat food sales are surging in supermarkets. Most customer surveys show that individuals perceive supermarket take-out food as fresher, healthier, and of better quality than restaurant food. New hypermarkets and huge discount plus grocery shopping complexes are offering one-stop shopping. Convenience stores are also challenging restaurants with take-out entrees. For example, 7-Eleven has 8,000 outlets and does more than \$700 million in annual food-service sales.

The family steakhouse industry is intensely competitive. Quincy's, Bonanza, Sizzler, Western Sizzlin, Steak & Ale, Western Steer, Golden Corral, and Family Steakhouse compete directly with Ponderosa. For example, Golden Corral, based in Raleigh, North Carolina, has expanded to thirty-three states, with 493 restaurants in 1987. Golden Corral's plan is to open 80 to 100 new units annually through 1992. Restaurants such as Shoney's and Denny's are also considered competitors because Ponderosa offers chicken and seafood entrees. Here we examine Ponderosa's two major competitors further.

#### *Professor's note*

*The information here lends itself to a SWOT analysis, at least as it affects the entire restaurant industry. One needs to ask, however, whether, as alleged in the case, the "family steak industry" is truly competitive. Do the listed firms compete with one another, or do they compete with individually-owned restaurants in their area? Is competition, then, site specific, regional, or national? And what is the implication of this finding? Or do they, in essence, compete with "themselves" for customer loyalty? Here it might be worthwhile to look into your own behavior with respect to eating out, and the choices that you make once this decision has been made.*

## Sizzler Steakhouses

Sizzler Restaurants International, Inc., is a 62 percent-owned subsidiary of Collins Foods International, Inc. Collins Foods is one of the largest franchisees of Kentucky Fried Chicken (KFC) restaurants, with 201 KFCs in the United States and 52 in Australia. Collins Foods also has 170 Naugles restaurants in the United States. Collins Foods' net income increased to \$20.9 million in 1987 on revenues of \$522 million, compared to a net income of \$4.6 million in 1986 on revenues of \$341.7 million. Company-owned Collins Foods' sales were up 15 percent to \$169.5 million in 1986, compared to \$146.8 million in 1985. Franchised Collins Foods' sales were up 13 percent to \$335.5 million, compared to \$296.5 million for the previous year. Collins Foods bought seventy-seven Rustler Steakhouses in 1985 and acquired the rights to twenty-four more in 1986. By June 1986, twenty Rustler Steakhouses had been converted to Sizzlers. Plans were made to convert sixty more during fiscal 1987.

Los Angeles-based Sizzler had 331 franchised restaurants and 153 company-owned restaurants in 1986, up from 327 and 138, respectively, in 1985. Franchised Sizzler restaurants include locations in Alaska, Guam, Japan, Hawaii, Kuwait, and Saudi Arabia. There are three company-owned and one franchised Sizzler in Australia. Forty percent of all Sizzlers are in California. A total of forty-eight Sizzlers were remodeled in fiscal 1986. Sizzler's average customer count per restaurant increased 7.4 percent in 1986 and average monthly sales increased 11.6 percent per restaurant. Total sales for fiscal 1986 increased to \$182 million from \$159 million in 1985. Net income in 1986 was \$11.7 million, up from \$9.9 million in 1985. Most Sizzler restaurants have recently introduced an enhanced menu including fresh fish, a soup bar, fresh fruit, and an expanded salad bar. Sizzler is transforming its image as a budget steakhouse serving working-class customers to a casual dinner house catering to a more affluent clientele. Among all the restaurant chains in the United States, Sizzler ranked eleventh in total television advertising expenditures for the first half of 1987. Sizzler spent \$9.6 million, an increase of 32 percent over the company's 1986 first-half figures.

### Professor's note

*Again, good information here for a comparative analysis of Ponderosa and other firms in the same industry. Note in particular the geographical concentration of what was then a smaller business when compared to Ponderosa. See, also, page.....*

## Bonanza Steakhouses

The Bonanza Restaurant Division is the dominant division of Dallas-based USA Cafes. As of September 1987, there were 588 Bonanza steakhouses operating under fifty-five area development agreement. Bonanza steakhouses are located throughout the United States (except in the Pacific Northwest), and in Canada, Puerto Rico, and Australia. Bonanza planned to open sixty-five restaurants in fiscal 1987. States with more than twenty-five Bonanza restaurants include Texas, Arkansas, Tennessee, Illinois, and Michigan. Plans are to begin expansion into the Far East soon.

Average annual sales per Bonanza restaurant were \$840,000 in 1986, up from \$776,000 in 1985 and \$738,000 in 1984. Net income in fiscal 1986 exceeded 1985 by 35.4 percent. The average Bonanza restaurant had a 6 percent increase in total customers in 1986, while the average increase for the industry was only 1 percent. Chainwide sales for Bonanza in 1986 were \$458 million compared to \$420 million in 1985, a 9 percent increase, while the restaurant industry as a whole increased on 2 percent. Bonanza's average weekly sales per restaurant increased from \$14,925 in 1985 to \$16,155 in 1986. Bonanza served approximately 94 million people in 1986, compared to 89 million in 1985. The average age of Bonanza's customers is thirty-two, down from thirty-nine a few years ago.

Bonanza is remodeling all of its restaurants to shed its traditional western image and to introduce a new, lighter, contemporary image. A sixty-item "Freshtastiks" food bar and new menu items that include broiled chicken and shrimp have been introduced. Bonanza restaurants are adding skylights over Freshtastiks food bars, replacing tile with carpet, using light-colored wood to replace dark interiors, and replacing wooden doors with glass doors. By the end of 1987, 73 percent of all its steakhouses were either recently remodeled or new. The Freshtastiks food bar continues to be a favorite, with 30 percent of Bonanza's customers ordering it as a meal in itself. Bonanza, is also continuing to offer "regional menus." Bonanza serves Mexican food in the Southwest, broiled scallops in the Northeast, and catfish in the South. A total of 37 percent of Bonanza's sales come from steak; 20 percent from chicken and seafood entrees.

Professor's note

*Same comments as made for the Sizzler chain of restaurants.*

## **Future Outlook**

Edelman plans to use franchising to expand Ponderosa's operations in new and existing markets. Ponderosa has both area development and individual agreements. Area development agreements give individuals the right to develop one or several steakhouses in a specific geographic area during a specific time period. Franchisees pay Ponderosa 4 percent of sales and must spend another 4 percent of gross sales on advertising of which 0.5 percent is paid to Ponderosa for system wide advertising. Ponderosa's franchising agreements require all building plans and sites for steakhouses to be approved by Ponderosa. Franchised restaurants must offer approximately the same menu and operate in the same general manner as company-owned steakhouses. Initial franchise fees during fiscal 1988 increased to \$25,000. On April 30, 1987, Ponderosa had sixteen area development agreements with sixteen different franchisees, who collectively plan to open 219 Ponderosa steakhouses over the next ten years, as follows: 1987 (23), 1988 (34), 1989 (40), 1990 (38), 1991 (31), 1992-1996 (53). There is no guarantee that these units will in fact be opened. Edelman took Ponderosa private on December 31, 1987. There has been no Annual Report or Form 10K for Ponderosa since that date. In addition to numerous hirings and firings, Edelman has made it clear that many other things will change at Ponderosa. He is seeking to dispose of the Casa Lupita chain of restaurants and ESI Meats. Rumors say that Michael Grisanti, chairman and president of the National Recovery Association, is interested in purchasing Casa Lupita. Edelman plans to consolidate office locations and administrative functions. He believes that consolidation will save Ponderosa \$7 million annually through improved efficiency.

Ponderosa currently owns three restaurants and franchises in one England, Taiwan, Singapore, and the Republic of China each have two Ponderosa Steak & Salad franchises. Edelman is trying to dispose of Ponderosa's company-owned steakhouses in England. He wants to develop in international markets only on a franchising basis. Food sales for Ponderosa's international division for fiscal 1987, 1986, and 1985 were \$2.7 million, \$2.4 million, and \$1.7 million, respectively. Additional revenues from franchise fees for the same years were \$147,000, \$103,000, and \$75,000, respectively.

Edelman is considering introducing a pasta bar and express buffet service at all Ponderosa restaurants. He plans to add an express salad line at lunch. In Ponderosa's 1987 Annual Report, Edelman summarized his outlook for the company:

"We look forward to fiscal 1988 as we focus on steakhouse operations, continue the remodeling program, and put an increased emphasis on franchising. Our goal is to franchise an additional fifty-five steakhouses in fiscal 1988, with the long-term objective to be two-thirds franchised by fiscal 1991. About \$20 million will be used for remodeling and maintenance of existing steakhouses. It is anticipated that capital expenditures will remain at reduced levels for the next several years. Ponderosa currently plans to remodel approximately seventy company-owned steakhouses in fiscal 1988, increasing the total number of remodeled steakhouses to about 190 by year-end. (p. 4)"

Do you think that Edelman's proposed strategies are right for Ponderosa? Was this takeover good or bad for Ponderosa's employees and customers? For Ponderosa's shareholders and creditors? What strategies would you recommend Ponderosa pursue now? How could the company best implement those strategies?

### END OF CASE

#### Professor's note

*Time now to answer the questions at the end of the case. Here a word of caution may be in order! The case was written in 1987, and much has transpired since then. If you have any knowledge of these events, try to avoid filtering them into your analysis. In other words, assume that the only knowledge that you have about Ponderosa is that which is presented in the case, and go on from there.*

*In this regard, Exhibit 8, as suggested earlier, can be quite helpful. The conventional wisdom in the restaurant and the supermarket industry is that market saturation is the best geographically oriented policy to follow, that is to say, that it is more effective strategy-wise to concentrate growth within a limited geographical area in order to build up and exploit brand name identities. What data does Exhibit 8 provide here? How would you then analyze it? How do you believe that this factor should influence Edelman's strategic thinking (if the contention on geographical concentration is, indeed correct).*



### **Professor's Summary Statement**

In point of fact, all that the author of this note knows about the Ponderosa operation is what he has learned from the case that you have now reviewed. To the best of his knowledge, there are no Ponderosa restaurants in the metropolitan area in which he lives nor does he remember seeing any during his various travels around the country. Because of this, he knows no more about Ponderosa, and possibly less than you do.

If he had to guess, he'd suggest that Edelman quickly spun off both the Casa Lupita and ESI operations in order to raise cash and simplify the management process. It also seems obvious that Edelman would move aggressively to expand franchisee operations because (a) this action does not require additional substantial sums of money to be invested in fixed assets, (b) it could lead to the geographical concentration noted above and (c) given the data in the case, properly managed, franchising can be a "cash cow".

Although there is no data presented in the case, the author of this note would also hazard the guess that the financial technique used by Edelman to take the company private was a debt-based recapitalization that committed the firm's free cash flow for a number of years into the future. By doing this, he and his fellow investors would recapture most of the \$235,000,000 in equity money that they previously invested in the company thus leaving them free to pursue other personal objectives. Ponderosa would not then be as profitable in the future as it had been in the past if return on sales is used as the criterion here. If return on equity is used as the guiding measure, however, the return to Edelman and his group for their net investment in Ponderosa could be huge. For an enhanced understanding of the rationale for this educated guess return to the firm's operating statements and add up the sums of money available from depreciation and amortization accounts assuming that future growth is franchisee dependent.

Again, a word of caution! The analysts knowledge here is limited. 20/20 hindsight may prove the analyst wrong but this then raises the potential for an up-dated Ponderosa case that takes a look at what actually transpired after the case was written, and the successes and/or failures that Edelman's management approach attained.