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investment report

Applebee's (APPB)

business overview

Applebee's International, Inc. (APPB) operates and franchises Applebee's Neighborhood Bar and Grill casual dining restaurants. Each Applebee's restaurant is designed to reflect the history of the local area and to maintain a neighborhood atmosphere. Applebee's offers a full service lunch and dinner menu. Restaurant bars offer beer, wine, hard liquor, specialty drinks, as well as non-alcoholic choices. Take out options include their new "Carside To Go" service which allows patrons to pick up their food without ever leaving their cars. The average guest check was around \$10.50 in 2005.

Applebee's is the largest casual dining concept globally and the tenth largest US restaurant chain. In the casual dining sector, Applebee's is ranked first in terms of number of units, sales, and market share in the casual dining sector. As of December 2005 there were 1,804 Applebee's restaurants located worldwide, only 486 are company owned. Of the company owned restaurants, the majority are located in the North Eastern United States as well as Minneapolis/St. Paul and Detroit/Southern Michigan. Every year for the past thirteen years Applebee's has consistently opened at least one hundred new restaurants and estimates a US market capacity of around 3,000 restaurants (currently at 1,738). They also estimate an international market capacity of 1,000 restaurants (currently at 72). In 2004, Applebee's announced a new alliance with the Weight Watchers program to offer ten Weight Watchers menu items.

Applebee's is currently headquartered in Overland Park, Kansas but anticipates relocating to newly acquired corporate headquarter space in the Kansas City metropolitan area in the latter half of 2007. David Goebel holds the position of President, CEO, and Director of Applebee's International, Inc. since August 2006. Applebee's IPO was in 1989. Since then, the stock has risen to a relatively stable trading price around \$22.50.

competition

competitor	company description	implications for APPB
Brinker International Inc. (EAT)	Developer, operator and franchiser of casual dining restaurants, including Chili's Grill and Bar. 1,510 units in 49 US states (primarily Southwestern) and 23 foreign countries (primarily Central American). Market cap: \$3.2 billion.	Strong competitor. Successfully leveraged buying power to save \$12 million in US last year. Planned expansion of Chili's in Middle East and Canada would threaten APPB introduction of similar American cuisine to those markets.
Darden Restaurants (DRI)	World's largest operator of casual dining restaurants, including Red Lobster and Olive Garden. 1,427 units in 49 US states and Canada. Average check: \$14.10. Market cap: \$5.2 billion.	Offers narrower, more focused range of cuisine than APPB. Strength of Red Lobster and Olive Garden brand names and success of newer brands expected to enable growth.



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<p>Ruby Tuesday, Inc. (RI)</p>	<p>Casual dining restaurant developer, operator and franchiser. 894 units in 29 US states (primarily East Coast) and 14 foreign countries (primarily Chile and India). Average check: \$10. Market cap: \$1.5 billion.</p>	<p>Weakened by 2004 scandal (waitress allegedly fired due to overweight appearance), and increased spending on marketing and remodeling projects. However, expected to benefit from overdue update to marketing campaign implemented in 2005.</p>
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financials

income statement

There are two factors that jump out when looking through Applebee's income statement. First, Applebee's revenues have been decelerating since 2003. While unit growth has been relatively stable varying from 6% to 8%, same store sales in the company owned stores (SSS) have significantly decelerated and actually declined in 2005. Given that the SSS in the franchise stores have not seen a similar trend, we believe that this may indicate a company execution issue. If the trend was similar between company owned and franchise stores than we may have been more willing to attribute to the change to higher gas prices (which prevent consumers from allocating the money not spent on gas on other things), but this does not seem this case for Applebee's. Second, operating expenses have grown very consistently with sales growth over the past six years. In our minds, this may indicate a lack of operating leverage – meaning that the company has little room to improve the efficiency of their operations or that this is not a focus of management.

APPLEBEE'S (APPB) INCOME STATEMENT

	2000	2001	2002	2003	2004	2005	2006 Est	2007 Est
Number of Stores								
							(consensus estimates)	
Company	285	310	357	383	424	486		
<i>yoy growth</i>		8.8%	15.2%	7.3%	10.7%	14.6%		
Franchised	1,001	1,082	1,139	1,202	1,247	1,318		
<i>yoy growth</i>		8.1%	5.3%	5.5%	3.7%	5.7%		
Total Stores	1,286	1,392	1,496	1,585	1,671	1,804		
<i>yoy growth</i>	10.1%	8.2%	7.5%	5.9%	5.4%	8.0%		

Comps - SSS

Company	2.0%	2.5%	1.8%	5.2%	3.8%	-0.9%		
Franchised	1.7%	3.0%	3.6%	3.7%	5.2%	2.7%		

Income Statement

Revenues	690	744	829	990	1,112	1,217	1,331	1,374
<i>yoy growth</i>		8%	11%	19%	12%	9%	9%	3%
Restaurant Oper Expense	511	552	617	729	824	938		
SG&A Expense	72	80	86	109	120	118		
Operating Income – EBIT	107	112	127	153	168	162	144	149
Interest Expense	8	6	1	0	0	3		
Other Expenses	(1)	5	(0)	(4)	(4)	(2)		
Taxes	37	38	46	56	60	56		
Net Income	63	64	81	100	111	105	84	87
Shares Outstanding (diluted)	89	85	85	85	84	80		
EPS	\$ 0.71	\$ 0.76	\$ 0.94	\$ 1.17	\$ 1.33	\$ 1.31	\$ 1.12	\$ 1.18
<i>yoy growth</i>	26.7%	6.4%	24.8%	24.4%	13.2%	-1.6%	-14.3%	5.4%



balance sheet

We see that assets and debts have increased, showing that Applebee's is accruing more debt as it purchases more property, plant, and equipment for expansion efforts. This provides further information that perhaps Applebee's is transferring its cash to invest in itself and its own equipment capital to drive its restaurants' growth.

APPLEBEE'S (APPB) BALANCE SHEET

	2000	2001	2002	2003	2004	2005
Assets						
Cash	12	23	16	18	11	13
Accounts Receivable	20	23	28	32	42	40
Inventories	13	10	12	21	36	20
Prepaid Expenses	6	12	15	18	12	17
Property, Plant, & Equipment	314	331	383	427	487	591
Other	107	101	114	136	167	198
Total Assets	472	500	566	651	754	879
Liabilities						
Short Term Debt	1	0	0	0	0	8
Accounts Payable & Accrued Payables	27	22	27	38	43	63
Accrued Expenses	66	76	87	101	109	126
Long Term Debt	90	75	52	21	35	180
Other Long Term Liabilities	6	3	6	38	71	88
Total Liabilities	190	175	174	198	258	466
Shareholders' Equity	282	325	393	453	497	413
Total Liabilities & Shareholders' Equity	472	500	566	651	754	879

statement of cash flows

Cash generated from operations have been consistently positive and grew each year from 2001 to 2003. After 2003, cash generated from operations decreased in 2004 but began to rebound in 2005. We see the biggest driver of these changes is coming from increase capital expenditures by Applebee's. This increase can be interpreted as higher costs for Applebee's to continue to grow their number of stores.

APPLEBEE'S (APPB) CASH FLOWS

	2000	2001	2002	2003	2004	2005
Net Income	63	64	81	94	111	102
+ Depreciation & Amortization	36	38	36	41	47	55
+ Changes in Working Capital	9	(2)	11	19	(8)	40
- Capital Expenditures	(46)	(50)	(65)	(83)	(112)	(139)
Free Cash Flow	62	50	62	73	37	59
Acquisition or Sale of Business	1	0	(34)	(12)	(14)	(47)
Cash Dividends Paid	(3)	(3)	(3)	(3)	(4)	(5)

valuation

Since Applebee's conference call in October, the P/E multiple has expanded, suggesting that investors trust the management's strategy to take on outstanding debts before setting aside more money to invest



outside of its company restaurants. This is a great contrast from the summer, when stock prices fell because Applebee's released expected earnings per share fell to increasingly lower ranges than that of private analysts, a reflection of multiple contraction. Investors in the summer took Applebee's modest EPS as a sign of future trouble.

Historically, Applebee's P/E has been between 8x and 22x. Currently, Applebee's is trading at a year forward P/E of approximately 21, a sign of positive sentiment that Applebee's management will be able to improve EPS going forward. Here, we must consider two factors. Firstly, the P/E is already nearing the historic P/E peak, so that the chances of Applebee's seeing multiple expansion to cause an increase in stock price are slim. Then consider the second factor, Applebee's ability to generate EPS growth. In our minds, Applebee's expansion in a saturated market will lead to diminishing and eventually negative returns with each new unit. With both these factors in play, we suspect that Applebee's stock is overvalued.



investment opportunities

dominant position

Applebee's is the market leader in the casual dining industry. Currently, three fifths of all Americans eat out at least once a week, and this rate is steadily growing as convenience becomes more and more valuable to busy Americans. Applebee's hopes to gain from this trend. The company, however, expects that due to increased development costs, slower sales trends within the restaurant sector, and the underperformance of many new company-owned restaurants, they will only open ten to fifteen company restaurants in 2007.

brand awareness

The company's expansion strategy is to expand in clusters in targeted markets, allowing Applebee's to take advantage of common operational, distribution, and advertising opportunities. Although it is relatively easy to enter the casual dining industry, Applebee's has a high level of brand awareness since



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it is the market leader in its industry sector. High levels of brand awareness mean high levels of brand loyalty which may help Applebee's to retain customers.

international expansion

Applebee's currently has seventy-two restaurants located outside of the United States, all of which are franchised. Applebee's estimates the international market capacity to be around a thousand units, meaning that the international market is not relatively penetrated at the moment. This offers a large opportunity for growth, however expanding the in international market is riskier for the company.

investment risks

declining sales

Applebee's International reported a 33% drop in third-quarter earnings despite a 5% increase in revenue. The company reported earnings of \$14.8 million down from \$22.1 million for the same quarter last year. The sales trend is not slowing. In November, Applebee's reported a 3.1% decline in same store sales. The decline reflects a 3% to 3.5% slump in guest traffic and a flat average guest check. Domestic same store comps are down at both company and franchise restaurants with declines of 2.2% and 2.1% respectively. November is the eighth month this year that the company has posted negative comps. Slow consumer traffic has been blamed on climbing gas prices but Applebee's has yet to see a 'rebound effect' despite falling fuel costs. The chain has also failed to motivate consumers with its recent food promotions from celebrity chef Tyler Florence which Applebee's heavily advertised. The chain also announced a 'modest' increase in menu prices for the 2007 fiscal year that might keep cost-conscious consumers away.

overextended finances

Applebee's International announced that it plans to allocate \$150 million to buy back company stock in addition to \$101 million remaining from an earlier plan to repurchase shares. Management has been authorized to seek additional financing to support this initiative. The chain has outgrown its original headquarters in Overland, Kansas and costs related to the construction of a new corporate headquarters in Lenexa, Kansas are estimated to approximate \$30 million in 2007. Applebee's also announced that it plans to open 10 to 15 company restaurants and 65 to 80 franchise restaurants in the 2007 fiscal year. Aggressive expansion despite negative traffic trends coupled with large capital expenditures could potentially hurt the chain.

substitutes

Although Applebee's has built brand loyalty, the chain is not unique. Its competitors, such as Brinker International, offer comparable services. If Applebee's were to raise menu prices significantly or if its competitors were to offer attractive specials and deals they could easily penetrate the restaurant's customer base.

little influence over suppliers

The competitive landscape of the casual dining industry limits Applebee's power with suppliers. If the chain were to demand a lower price for food and equipment, its suppliers could easily find alternative clients.