Strategic Report

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Background

Operations

Wendy's International, Inc. was incorporated in 1969 in the state of Ohio. Currently the company owns and operates three different brands of restaurant and each one represents a different concept.

Wendy's International Inc., incorporated in 1969, is primarily engaged in the business of operating, developing and franchising a system of distinctive quick-service and fast-casual restaurants. The Company has 6,253 Wendy's restaurants in operation in the United States and in 21 other countries and territories. Of these restaurants, 1,320 are operated by the Company and 4,933 by its franchisees.

Each Wendy's restaurant offers a relatively standard menu featuring hamburgers and filet of chicken breast sandwiches, which are prepared to order with the customer's choice of condiments. Wendy's menu also includes chicken nuggets, chili, baked and French fried potatoes, prepared salads, desserts, soft drinks and other non-alcoholic beverages and children's meals. In addition, the restaurants sell a variety of promotional products on a limited basis.

Generally, the Company does not sell food or supplies to its Wendy's franchisees. However, the Company has arranged for volume purchases of many of these products. Under the purchasing arrangements, independent distributors purchase certain products directly from approved suppliers and then store and sell them to local company and franchised restaurants. These programs help assure availability of products and provide quantity discounts, quality control and efficient distribution. These advantages are available both to the Company and to any franchisee that chooses to participate in the distribution program.

The New Bakery Co. of Ohio Inc., a wholly owned subsidiary of the Company, is a producer of buns for Wendy's restaurants. As of December 29, 2002, the Bakery supplied 706 restaurants operated by the Company and 2,160 restaurants operated by franchisees. The Bakery does not manufacture or sell any other products.

As of December 29, 2002, the Company and its franchisees operated 2,348 Tim Horton's restaurants, with 2,188 restaurants in Canada and 160 restaurants in the US. Of these restaurants open as of December 29, 2002, only 71 were Company-operated.

Each Horton's unit offers coffee, cappuccino and freshly baked goods, including donuts, muffins, pies, croissants, tarts, cookies, cakes and bagels. Some units also offer sandwiches, soups and freshly baked breads.

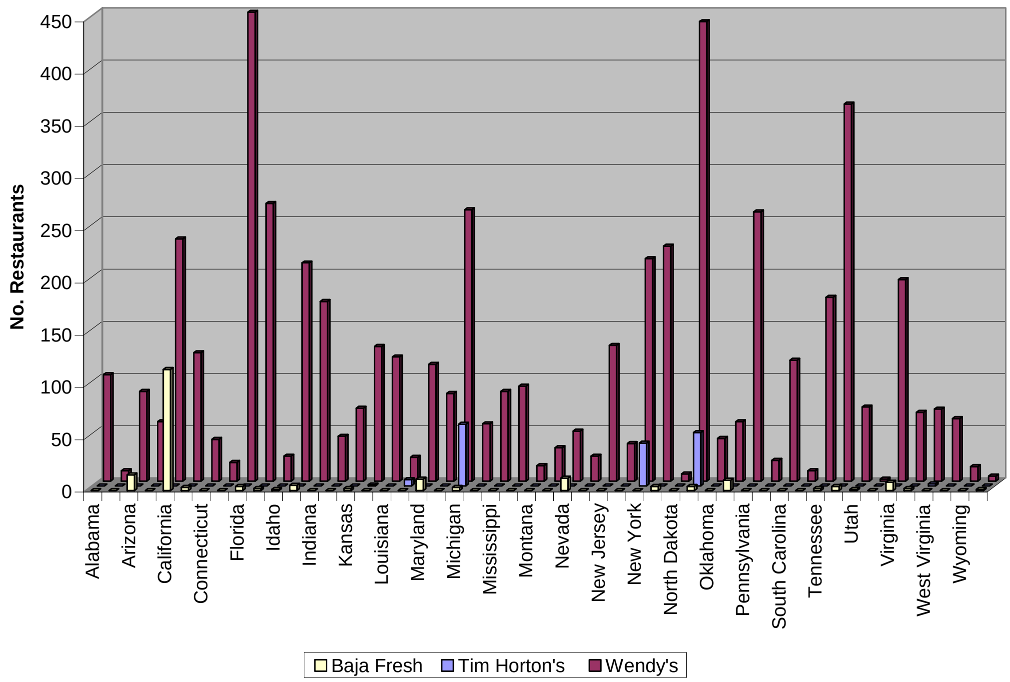
Under the Horton's Canada franchise arrangements, the franchisee is required to purchase certain products such as coffee, sugar, flour and shortening from a Horton's subsidiary. These products are distributed from five warehouses located across Canada. Products are delivered to Horton's Canada restaurants primarily by Horton's fleet of trucks and trailers. Both Company and franchise stores of Horton's in the United States purchase products from a supplier that has been approved by Wendy's International.

Wendy's International and its franchisees operated 210 Baja Fresh restaurants in 19 states and the District of Columbia as of December 29, 2002. Of these, 98 were Company-operated Baja Fresh restaurants and 112 were franchise restaurants.

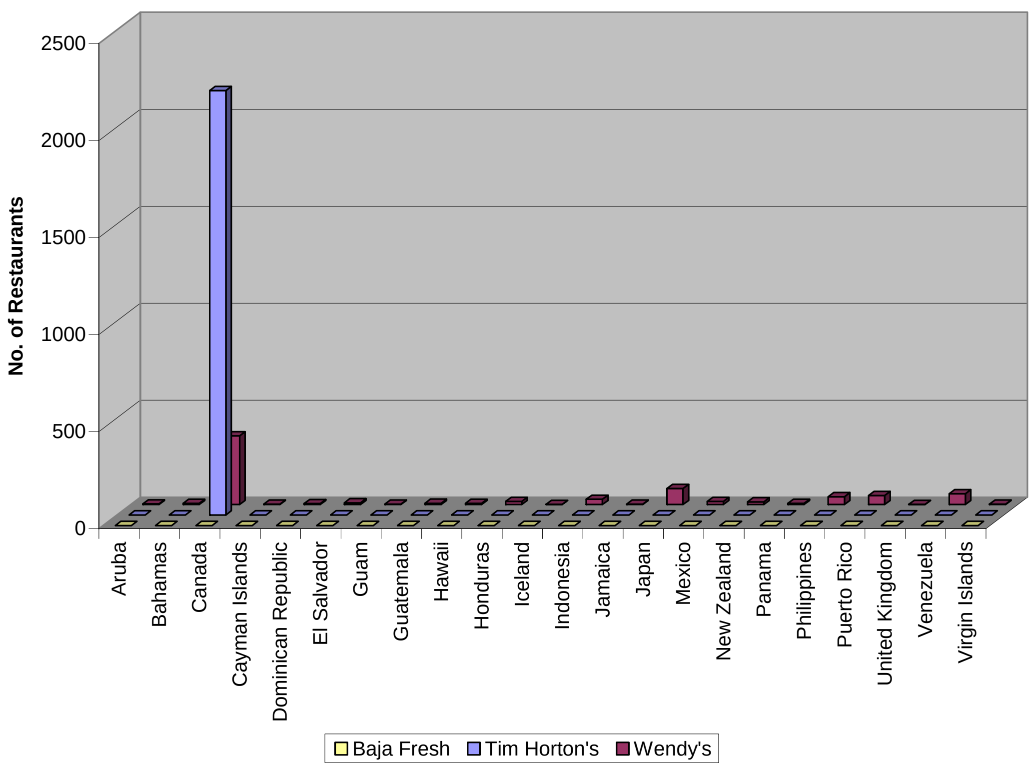
Baja Fresh offers a range of fast-casual, fresh Mexican food. The menu includes a variety of food, including burritos, tacos, quesadillas, nachos, tostadas, beans and rice.

Geographic distribution of stores

Domestic – 5919 restaurants spread in 50 states



International – 2892 restaurants spread in 22 countries



Industry Niche

Innovator in the Industry

An Industry Innovator in Menu and Service, Wendy's continues to set itself apart from the competition with both menu and service innovation. Wendy's was the first to introduce the modern day pickup window (62% of Wendy's North American sales today), the first to roll out a national late night program (about 10% of sales today), and the first to roll out an everyday 99 cent menu.

Wendy's menu innovations have been an important part of its ongoing growth and consumer brand loyalty. In addition to the company's trademark square hamburgers, menu highlights over the years have included salad bars (introduced in 1983), baked potatoes (1983), the Big Bacon Classic (1986), the Grilled Chicken Sandwich (1990), Salads to Go (1992), Crispy Chicken Nuggets (1996), the Spicy Chicken Sandwich (1996), Fresh Stuffed Pita (1997), and recently, the new Garden Sensations salads (2002).

Quick Service Industry Trends Introduced by Wendy's

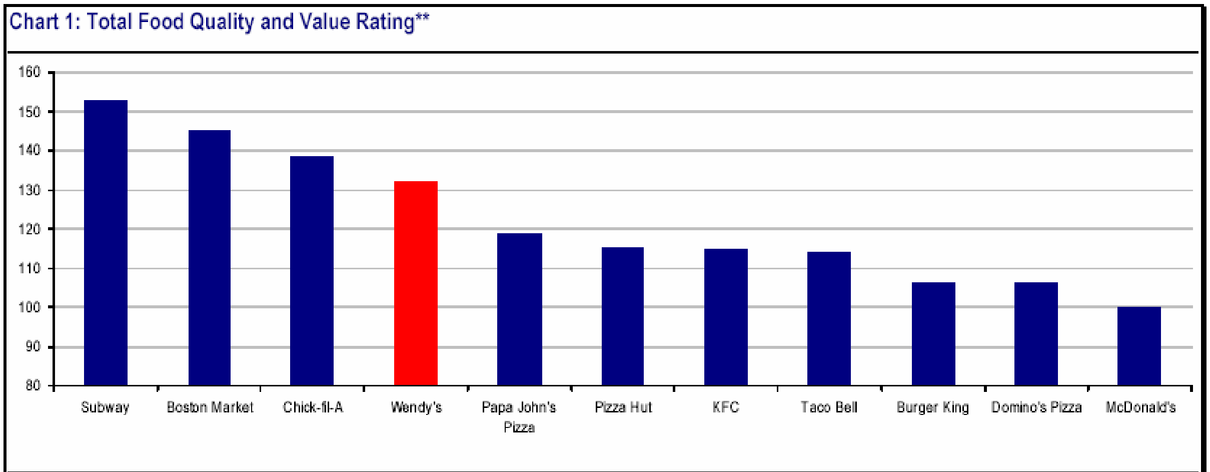
1971	Modern Day Drive-Thru Window
1979	Salad Bar
1989	99 cent Super Value Menu
1995	Late Night Program
1997	Fresh Stuffed Pitas

Source: Company Reports

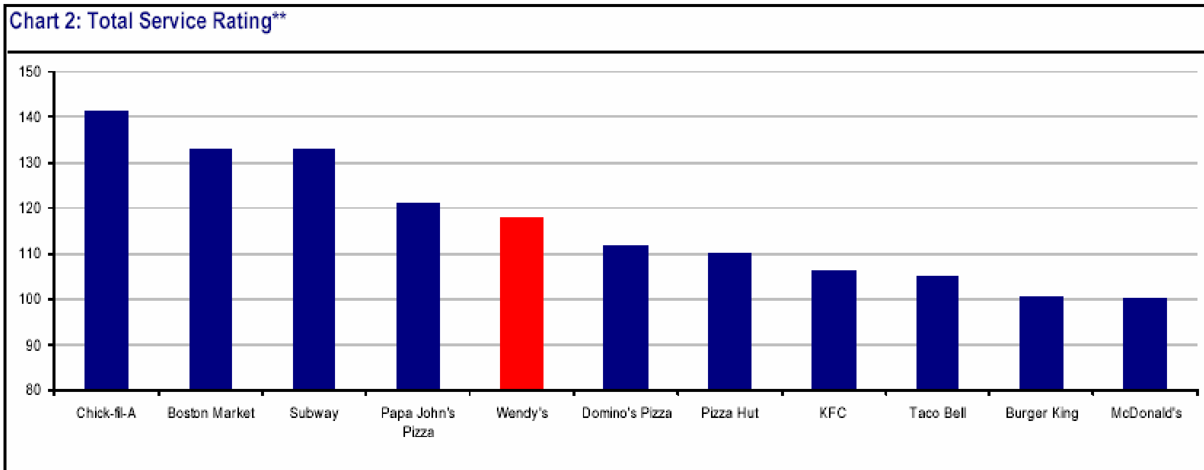
Qualitative Factors

Consumers rate Wendy's as the leader in food quality. Wendy's continues to abide by many of Dave Thomas' founding principles regarding product quality. Using only fresh beef (not frozen) and fresh salads prepared in the restaurants (not pre-packaged), Wendy's has been able to attract loyal customers, building a food image centered on quality. According to a recent industry survey, Wendy's received 23 No. 1 rankings out of 25 food categories (Source: Wall Street analysts' reports).

Most Recent Rankings



**Combination of food taste, food appearance, value for the money, reasonable menu prices and menu variety.
Source: Technomic Information Services; Sandelman & Associates; UBS analysis



**Combination of attentiveness and friendliness/ courteousness of the staff.
Source: Technomic Information Services; Sandelman & Associates; UBS analysis

Overall 2003 Fast Food Industry Ranking

Restaurants & Institutions: 2003 Choice in Chains

Overall		Cleanliness		Quality		Variety		Value		Service		Atmosphere		Convenience	
	Score		Score		Score		Score		Score		Score		Score		Score
Subway	49	CFA	47	Subway	66	Subway	57	Subway	49	CFA	48	CFA	37	MCD	50
CFA	46	Subway	42	CFA	63	WEN	52	**Taco Bell**	48	Subway	47	Sonic	33	Subway	49
WEN	44	WEN	39	PZZA	58	Sonic	47	WEN	46	Sonic	43	**LJS**	32	WEN	46
Sonic	41	Arby's	35	**Pizza Hut**	68	Arby's	46	CFA	42	PZZA	40	Subway	30	BK	44
Arby's	39	Sonic	34	Arby's	57	JIB	46	PZZA	41	WEN	38	WEN	30	Sonic	44
Pizza Hut	39	**Pizza Hut**	32	WEN	57	CFA	45	**LJS**	41	Dom	37	**Pizza Hut**	30	**Taco Bell**	44
LJS	38	PZZA	31	Pop	53	**Pizza Hut**	43	MCD	38	**LJS**	36	Arby's	27	Dom	44
PZZA	38	Dom	31	**KFC**	50	**LJS**	41	JIB	38	**Pizza Hut**	35	Pop	25	PZZA	41
JIB	36	Pop	31	Sonic	48	**Taco Bell**	41	Dom	37	Arby's	35	PZZA	24	CFA	40
Pop	36	JIB	29	**LJS**	45			Pop	37	**Taco Bell**	31	Dom	22	**Pizza Hut**	40
Taco Bell	36	**KFC**	29	JIB	45			BK	36	Pop	31	**Taco Bell**	22	**KFC**	39
Dom	35	MCD	28	Dom	45			Sonic	36	JIB	31	JIB	22	JIB	39
BK	33	BK	28	**Taco Bell**	39			Arby's	35	**KFC**	30	MCD	22	Arby's	38
MCD	33	**Taco Bell**	27	BK	37			**KFC**	34	MCD	29	**KFC**	21	Pop	37
KFC	31			MCD	30			**Pizza Hut**	33	BK	38	BK	19	**LJS**	37

Key:
BK = Burger King JIB = Jack in the Box Pop = Popeye's
CFA = Chick-fil-A LJS = Long John Silver's PZZA = Papa John's
DOM = Domino's MCD = McDonald's WEN = Wendy's

Source: Source: Restaurant and Institutions 2003 Choice and Chains ratings, Fall 2002

Franchise System that Works

Over 82% of all restaurants are operated by franchisees. The Wendy's culture—which is deeply rooted in Dave Thomas' "way"— is predicated on the understanding that the company is there to support the franchisee. Wendy's franchisees have become rich following Dave's way during the 1990s and are now the most financially sound franchisee base in the industry (with the possible exception of Applebee's franchisees). Over the last 12 years, average unit volume growth at Wendy's restaurants exceeded all other major competitors with a 3.7% per annum clip. The extra $440,000 in average unit sales gained by the average unit has done wonders for unit profitability.

Domestic Average Unit Sales Volume Change for Leading Quick Service Restaurants:

	1990	2002	Growth	CAGR
Wendy's	$811	$1,251	$440	3.7%
KFC	$650	$964	$314	3.3%
Pizza Hut	$607	$748	$141	1.8%
Taco Bell	$771	$898	$127	1.3%
Burger King	$955	$1,030	$75	0.6%
McDonald's	$1,455	$1,531	$76	0.4%

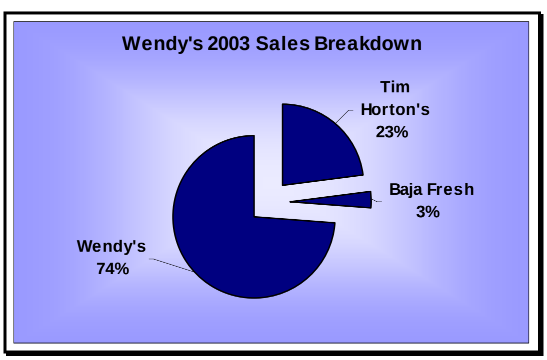
Source: Company disclosure; UBS estimates

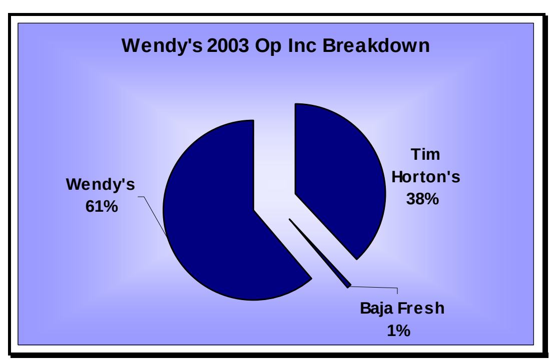
Furthermore, the franchisee base has for the most part owned the land under their restaurants—often allowing franchisees to accrue substantial capital gains on prime commercial real estate, along with retaining cash flow that would otherwise go to rent.

Financial Description & Position in the Industry

2003 SALES - $3,149MM

2003 OPERATING INCOME – $418MM





2003 PROFIT – $236MM

In terms of net income, Baja Fresh accounted for $2.5MM of losses in 2003 (or $0.09/share vs. forecasted $0.03-0.04), Tim Horton's accounted for over 40% of 2003 profits and Wendy's accounted for the rest.

Market Share

Wendy's is the third-largest quick service restaurant in the US (3.7% market share) behind McDonald's (10.8%) and Burger King (4.7%).

In the limited service hamburger segment, the company comes in at No. 3 with a 14.4% share, behind Burger King (17.5%), and well behind industry leader McDonald's at 42.7% share.

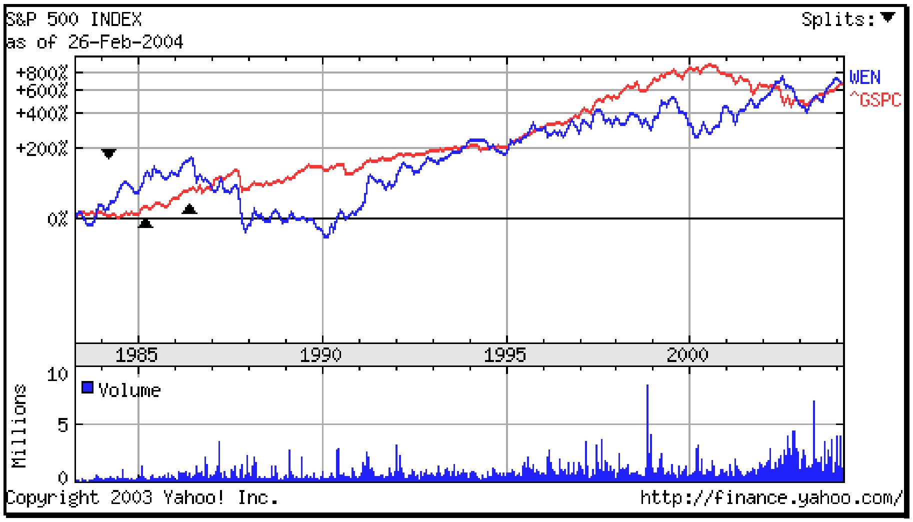
In Canada, Wendy's Tim Horton's stores have a 22% share of the quick service market. They are the largest quick serve coffee retailer with a 70% share. Outside of North America, Wendy's has a much smaller presence relative to its competitors - 350 units at the end of 2002 outside of North America. This contrasts with 15,230 for McDonald's excluding Canada and an estimated 10,300 for Yum! Brands.

Comparison with Competitors

Comparison with Competitors

	McDonald's	**Yum Brands**	**Wendy's**
(in $MM) except No. of restaurants			
Total Restaurants	31,108	33,000	8,811
Brands			
(majority onwership)	McDonald's	KFC	Wendy's
	Boston Market	Pizza Hut	Tim Horton's
	Chipotle Mexican Grill	Taco Bell	Baha Fresh
	Donatos Pizzeria	Long John Silver's	
		A&W All-American food restaurants	
(minoroty onwership)	Pret A Manger		Café Express
% Franchised	57%	<70%	82%
Market Value	$35,245	$10,454	$4,537
2003 Sales	$15,405	$8,390	$3,040
Total Assets	$25,093	$5,609	$2,785

Financial Analysis



Since its initial public offering on April 6, 1983, Wendy's stock has increased in value approximately 13.6% each year on average, compared to the S&P 500 – 10.1%. Recently, the stock is trading at an all-time high, slightly above $40.00.

Valuation

Valuation - comparison to competitors	McDonald's	Yum Brands	Wendy's
Beta	0.75	0.35	0.36
P/E (LTM)	23.0x	17.7x	18.9x
P/Sales (TLM)	2.0x	1.3x	1.4x
Price to Book (LTM)	3.0x	9.3x	2.5x

(LTM) - Last Twelve Months

The P/E ratios of the three companies are similar and below the market P/E of approximately 30. This reflects the low growth potential of the companies stemming from the fact that they are in a mature industry. Price to sales ratios as well as price to book ratios of the companies are also low, again reflecting the fact that they are in a mature industry. Exception is YUM's price to book ratio, which is surprisingly high which is due to the fact that YUM has much better asset turnover. YUM achieves that through successfully utilizing the franchising model (the company has 33,000 restaurants almost 70% of the them are franchised and do not appear as assets on its balance sheet, in comparison MCD has 31,000 restaurants and only 57% of them are franchised). Overall, Wendy's stock valuation is in line with peers in the industry.

Management Effectiveness

Management Effectiveness - comparison to competitors	McDonald's	Yum Brands	Wendy's
Asset Turnover ($)	0.70	1.51	1.11
Return on Assets (%)	6.11	11.11	8.28
Receivable days	16.94	7.86	12.24
Inventory days	3.44	3.85	9.35
Revenue per emploeyee	$41,502	$107,326	$342,273

Wendy's current asset turnover (ATO) of 1.11 shows that the company generates $1.11 for every $1.00 of assets it owns, this result is better than MCD's 0.70, yet lags significantly behind YUM's 1.51. The difference in the ATO between YUM and MCD comes mainly from the difference in percentage franchised restaurants each company has. Note that even though 82% of Wendy's restaurants are franchised compared to 70% for Yum Brands, Wendy's still generates $0.40 less per $1.00 of assets it owns. Wendy's ROA (calculated as *Net Income* divided by *Total Assets*) of 8.28 shows that the company generates $0.83 of *Net Income* for every $1.00 of assets it owns. Since the companies' profit margins are very similar, the difference between the three companies' ROA is due to the different asset turnover. In terms of days it takes to collect its receivables and days it takes to replace its inventory on average, Wendy's lags behind the leader Yum Brands but performs better than MCD. Wendy's manages to use more effectively its personnel, which is shows in the revenue per employee statistic. To conclude, Wendy's lags significantly behind YUM in terms of asset utilization which comes from YUM has better management at operating (managing restaurants) as well as corporate level (strategy – supplies, advertising, franchising, etc.), but WEN manages to better utilize its human capital.

Profitability and Returns

Profitability and Returns	McDonald's	Yum Brands	Wendy's
Gross Margin (LTM)	30%	24%	27%
Gross Margin 5-yr Average	33%	24%	28%
Operating Margin (LTM)	14%	13%	13%
Operating Margin 5-yr Average	21%	13%	13%
Net Income Margin (LTM)	9%	7%	8%
Net Income Margin 5-yr Average	12%	7%	8%
Return on Invested Capital (LTM)	9%	17%	10%
Weighted Avg Cost of Capital	7%	7%	7%
Value Added=ROI-WACC	3%	10%	4%

(LTM) - Last Twelve Months

The low gross margins (GM) of the companies (Sales – Costs of Goods Sold) reveal that the industry is highly competitive, which limits companies' abilities to charge high prices. Wendy's GM is 27%; in comparison Microsoft's net income margin (net income as % of sales) is 26%. The low GMs transform into low operating income margins, which are not surprisingly very similar for the three companies, primarily due to the convergence of profitability typical for mature industries. Given the similar operating margins of the three companies, McDonald's higher net income margins is due to the fact that the company is less indebted which results in a lower interest payment and its effective tax rate is lower. The comparison of LTM margins to the five year average margins shows that MCD has had some monopoly power in the past allowing the company to make higher profits than its competitors. Yet, over time the operating margins of the three companies have converged.

In terms of returns on invested capital (ROIC) (operating income divided by the sum of total debt and total book equity), WEN and MCD are significantly lagging behind YUM. YUM's advantage in ROIC stems from the higher utilization rate of the company's assets, which was discussed in the previous section. Consequently, YUM delivers a higher value added (defined as the difference between the return on invested capital and the weighted average sum of cost of debt and cost of equity.

Financial Condition and Dividends

Financial Condition and Dividends	McDonald's	Yum Brands	Wendy's
Total Debt to Equity	0.81	1.85	0.42
Interest Coverage (LTM)	5.77	8.08	9.14
Dividend Payout ratio	67%	0%	12%
(LTM) - Last Twelve Months			

Of the three companies, only Yum Brands is highly leveraged. Wendy's has the least amount of debt financing as the total debt to equity ratio shows. With cash flow from operations five to nine times larger than the companies' interest payments, none of the three companies has any liquidity or solvency problems. Being mature businesses with steady cash flows, WEN, YUM and MCD can raise significant amounts of debt financing at a relatively low cost.

Wendy has distributed between $27MM and $29MM of dividends consistently over the past five years. Recently, the company increased its dividends by 100% and the fraction of net income it distributes to stock holders as dividends is currently 12%. Even though the company still earns returns on invested capital larger than the cost of capital, an increase in dividends is a signal that the company is unable to reinvest its earnings in projects with high returns and does not plan significant expansion. Furthermore, the company has repurchased stock in four out of the last five years, which is another way to distribute earnings to shareholders. The amounts of these repurchases in some years are up to nine times larger than the amount of dividends paid in the same year. MCD is distributing a significantly larger percent of its earnings to stockholders as dividends and stock repurchases and Yum Brands is not paying any dividends but is repurchasing some stock each year.

Growth

Growth	McDonald's	Yum Brands	Wendy's
Sales Growth (LTM)	11%	8%	15%
Sales 5-yr Growth Rate	6%	0%	10%
EPS Growth (LTM)	54%	7%	9%
EPS Growth 5-yr Growth rate	-8%	7%	17%
Capital Spending 5-yr Growth Rate	-1%	8%	-100%

(LTM) - Last Twelve Months

Wendy's is the fastest growing company of the big three in the fast food industry. LTM growth rates of sales and EPS of all three companies are significant and largely attributed to the economic recovery of the country in the past year. Looking at five year compounded growth rates shows that Wendy's is far ahead of its direct competitors with sales growing at 10% and EPS growing at 17%. Wendy's growth is not expected continue at the same rates, at the beginning of February 2004, the management lowered long-term EPS growth from 12% - 15% to 11% - 13%. Further evidence for lower future growth are the increase in dividends, current levels of stock repurchases and the 100% decrease in capital spending over the last five years.

Looking at the current stock price of $40.67, Wendy's expected future growth is far less than 11% - 13%. If one values the current earnings per share of $2.12 as a growing perpetuity and uses 6.6% as a weighted average cost of capital (Morgan Stanley's estimate), the implied perpetual growth rate of Wendy's EPS is 1.48%.

Porter's Five-Forces Analysis

Internal Rivalry

Wendy's competitors are restaurants selling burgers, fries, pizza, fried chicken, sandwiches and Mexican food. National rival food chains can be grouped in the following categories:

Burgers/ Sandwiches	Pizza	Chicken	Mexican Food	Healthier Alternatives	Coffee and Donut Shops
McDonald's Burger King Jack in the Box Carl's Jr. / Hardee's	Round Table Domino's Little Caesar Papa John's Pizza Hut	Kentucky Fried Chicken, Popeye's Fried Chicken	Taco Bell	Quiznos, Subway,	Starbucks Krispy-Kreme Dunkin Donut

There are no incidents of cooperative bargaining on the fast food market, in fact, firms often engage in price wars through promotional campaigns such as $0.99 menus. The lack of cooperative bargaining is primarily due to the fact that the industry is highly fragmented, there is over 40,000 fast food restaurants in the US owned by a number of large corporations as well as small firms. Carnegie Consulting computes the HH-Index for the hamburger-sandwich chain market to be approximately 1,700, which is the equivalent of six firms of equal size. In Canada, Tim Horton's has a slight advantage since it has the largest share and competition is not as fierce as in the US and price wars do not occur. Yet, Tim Horton's does not have higher than expected profitability. Baja Fresh, which present mainly in California, also has a large number of competitors, most of them small family owned restaurants.

Brand loyalty is hard to retain in the fast food market because of the low switching costs for customers. Furthermore, since the fast food products are relatively not differentiable, customers value proximity of the restaurants more than its menu. Customers at Tim Horton's' have less alternative brands to turn to, but competitors such as Starbucks, Dunkin Donut and Krispy Kreme that are significantly larger, spend more on advertising and building brand loyalty.

The franchising model is popular among all large fast food chains, as it allows firms to delegate control of the restaurant to the franchisee and thus overcome agency problems. The franchising model helps companies adjust quicker to the changing conditions of the overall fast food market as well as to respond to changing conditions with different strategies on different geographic markets.

Growth in the overall fast food market is slightly higher than the inflation level today reflecting the high saturation levels of the fast food industry. Thus, firms focus on increasing market share through improving customer satisfaction by lowering prices and increasing food quality. Consequently, competition is fierce.

Substitutes and Complements

Substitutes to the fast food restaurants include home cooking, sit down restaurants, convenience stores and specialty food retailers:

Sit-down restaurants	**Convenience stores**	**Specialty-food retailers**	**Home cooking**
Applebee's Chili's Denny's Olive Garden, Etc.	7-11 AM/PM Gas stations	Starbucks Dunkin Donuts Krispy Kreme	

Convenience stores are the closest substitutes for Wendy's and Baja Fresh restaurants. Convenience stores offer sandwiches, hamburgers, hot-dogs, tacos, burritos, drinks, etc. often at prices lower than fast food restaurants. Even though they lack drive-thru service, consumers often shop there for fast food because they are generally looking for convenience and value. Such stores serve the late night customers and are often paired with gas stations in order to create economies of scope.

Coffee and donut shops such as Starbucks, Dunkin Donut and Krispy Kreme are direct substitutes for Tim Horton's and have a significantly larger number of restaurants. Switching costs are also low and location/convenience is more important to customers than menu and brand preference.

Sit-down restaurants are substitutes but not as close as convenience stores and specialty-food retailers because of their higher prices and different value propositions.

Home cooking is another alternative. The popularity of home cooking has been constantly decreasing over the last few decades and the trend is expected to continue.

Complements to fast food restaurants include businesses that pair well, such as gas stations, retailers, shopping malls, sports stadiums, etc. Larger chains such as McDonald's have locations attached to Chevron gas stations and locations within Wal-Mart stores, Home Depot stores, Disneyland, and in malls and airports. Wendy's has not developed such symbiotic relationships.

Entry

Entry in the fast food market could be looked at from the perspective of a national fast food chain and from the perspective of a single restaurant operator.

Barriers to entry for national fast food chains are substantial. They include the large capital requirements to open restaurants, and the large upfront advertising expenses needed to increase brand awareness. Also, the difficulty of finding a location with sufficient traffic of people and few competing restaurants creates another barrier to entry. Thus, new large players on the fast food market do not appear often. Since growth of existing brands for most fast food restaurants is slowing down, companies acquire developing small regional chains with specific themes, such as Mexican food in California, in order to grow. Another type of entry for large fast food chains is placing restaurants in places where customers historically have not seen them, i.e. food courts in shopping malls, Home Depot, etc. Lastly, large fast food companies' have mainly grown internationally in recent years. As working hours and living standards increase all over the world, more people tend to eat in fast food restaurants and firms such as McDonald's and Yum Brands are rapidly opening new units overseas.

Barriers to entry at a local level are relatively low, except for finding a suitable location, fixed upfront costs for both franchisees and people who operate their own brands of restaurants are relatively low. Seven out of ten restaurants in the US are run by small operators. This number is most likely smaller in the fast food market since it's dominated by large chains, yet small operators are a significant part of that market. Low barriers to entry at a local level are evident in the fact that 80% of all restaurants go bankrupt within one year after opening, yet the number of total restaurants in the US is constantly increasing.

Buyer and Supplier Power

Suppliers in the fast food industry supply meat, vegetables, dairy products, non-alcoholic beverages, machinery and labor. All of these products are common and the market for each of them is highly fragmented, therefore, many suppliers of relatively undifferentiated products exist in the fast food market.

Some fast food chains produce a large part of their inputs (McDonald's and Yum Brands), some use authorized suppliers (McDonald's and Yum Brands) and some allow franchisees/restaurant owners to choose their own supplier (Wendy's, Yum Brands). Looking at the gross margin of MCD, YUM and WEN, one can see that they are fairly similar (given that companies do not disclose what types of costs they include in the *cost of good sold*), therefore there is no evidence that supplier power exists among food suppliers in the fast food market. Fast food chains on the other side are only a small part of the buyers of beef, chicken, vegetables, sodas, etc. and therefore have limited power over suppliers. Even though some companies such as McDonald's have limited the number of suppliers they work with (for example the number of their beef suppliers decreased from over 170 to 5 in the last 30 years), this is most likely due to quality control issues rather than the existence of supplier power.

Equipment and labor are of secondary importance to the fast food chains. Equipment is purchased rarely and is specific to fast food restaurants primarily which are consequently the main buyers of these products and therefore supplier power is relatively low. The primary workers in fast food restaurants are non-unionized, part-time employees under 25 and the annual turnover in the fast food restaurants is close to 100%. Employee training is of small cost. Therefore, workers in the fast food industry have almost none supplier power.

Buyers in the fast food industry are individuals and families and the volume of purchases of every individual customer is minimal compared to the overall volume of sales of a given fast food restaurant. Yet, because of the existence of many close substitutes to fast food and the relatively low switching costs, buyers possess some power. This is evident in the operating margins of WEN – 13%, MCD – 13% and YUM – 14%. Individual franchisees also do not have significant buyer power over any of the fast food chains. Franchising rights cost twice as low at Wendy's than at McDonalds, but this could be attributed to factors such as the larger value of McDonald's brand name, the fact that MCD's franchisees are provided with supplies whereas WEN's franchisees for the most part look for their own suppliers, etc.

Evaluation of Key Issues

Issue One: Baja Fresh – Currently Unprofitable

Baja Fresh is growing rapidly, opening 73 new restaurants in 2003 and increasing revenue approximately 28%. Baja Fresh currently represents about 5% of the Wendy's revenues and enjoys the highest average sales per restaurant in the fresh Mexican, fast casual segment at $1.4 million. However, Baja Fresh was not profitable as a segment in 2003 due to declining average sales and increasing costs. Average same-store sales decreased in company operated units by 3.3%, compared to an increase of 2.9% in 2002. At the end of 2003, there were 132 company operated units compared to 98 at the end of 2002. Average same store sales decreased in franchise operated units by 5.9%, compared to an increase of 2.5% for 2002. At year-end 2003, 151total franchise restaurants were open compared to 112 at the end of 2002. The increases in reported Baja Fresh 2003 cost of sales and company restaurant operating costs over 2002, and 2002 over 2001, are substantially due the timing of the company's acquisition in mid-2002. As a percent of sales, these costs increased from 2002 to 2003 due to higher beef and other food costs and lower average same-store sales.

In order to turn Baja Fresh into a profitable venture, PAC Consulting recommends a strategy that includes:

- **Continuing to add new stores**

  The Mexican food segment of the fast-food market is relatively new and offers significant growth opportunities. Chains such as Baja have a short history and are still building brand awareness in order to attract repeated clientele. Continuing to add new stores locally will help the company exploit the popularity of its brand in Southern California and capitalize on the historical trend of large sales volumes per unit.

- **Increasing brand awareness**

  Baja is among the most popular Mexican food chains in Southern California, however as the number of stores is rapidly increasing, new stores are being opened in Central California and will be opened in Northern California. As the company is expanding outside of its traditional geographic parameter, it will face challenges to maintain the high volume of sales per unit in the new areas because of lower local brand awareness. The company thus needs to streamline advertising efforts on a company level in order to build brand equity in the newly developed areas.

- **Enhancing operations and the customers' experience**

Currently, Baja's operating expenses are larger as percentage of sales than Wendy's, Tim Horton's and those of other competitors. The high operating expenses are due primarily to the large number of field offices the company uses to manage Baja Fresh restaurants. The company owns and operates Baja Fresh restaurants in 12 states other than California. Franchising these restaurants will allow the company to close the local field offices, which are operating inefficiently due to the small number of local restaurants, precluding the field offices from developing economies of scale. Baja's restaurants in California are clustered in a relatively small geographic area and some of the field offices should be merged in order to further increase efficiency of operations.

The quality of food in Baja Fresh has been slowly deteriorating in the past several years (PAC Consulting survey), which is partially due to mismanagement and partially to the increase of the number of items on Baja's menu. Lower food quality inevitably aggravates customers experience and affects sales negatively. Thus, the company needs to focus efforts on stimulating management and employees to focus on the quality of the food and also needs to reduce the size of its menu.

- **Menu reduction**

A larger and often changing menu is associated with additional employee training and extra expenses, furthermore, as employees' actions become less routine, they also become less efficient, thus more employees are needed, which again is associated with additional costs. A more extensive menu also means that managers must order more supplies, which complicates their work and increases the probability that some items will not be available for customers. Thus, Baja needs to maintain a relatively small menu and to keep it consistent through all of its restaurants and over time (to the extent possible).

- **Building average sales per restaurant**

Even though Baja enjoys the highest levels of sales per unit, PAC Consulting believes that the company can grow these sales even further. This can be achieved through streamlining advertising efforts at a local level and promoting each restaurant in the area from which it drives most of its customers.

PAC Consulting believes that the concept has great potential for the future. Nevertheless, as with all young companies, there are challenges to gaining customer acceptance, especially in such a competitive industry.

Issue Two: Long-Term Growth

In February 2004, Wendy's disclosed its long-term annual EPS growth goal of 11% to 13%, down from the previous 12% to 15%. Also at the beginning of 2004, the company increased dividends by 100%, thus the current payout ratio of Wendy's is about 6%. Stock repurchases are part of the ongoing financial strategy utilized by Wendy's, and normally come from cash on hand and the cash provided by exercised stocks options.

A total of 597 new restaurants were added in 2003. Current plans call for 550 to 600 new company and franchise restaurants to open in 2004. The Company expects 2004 capital expenditures to be in the range of $300 million to $350 million for new restaurant development, remodeling, maintenance and technology initiatives. This range is consistent with capital expenditure spending over the last several years. The number of anticipated 2004 restaurant openings is consistent with the last several years and is expected to be concentrated in the Wendy's North America and Horton's Canada markets.

Wendy's has historically been financing growth through a mix of retained earnings and borrowing, as retained earnings have been used primarily to finance organic growth, whereas, debt-financing has been used to finance acquisitions. The long-term debt-to-total equity ratio declined to 39% at year-end 2003 from 47% at year-end 2002. This primarily reflects an increase in retained earnings from 2003 net income and an increase in accumulated translation adjustments due to the stronger Canadian dollar. Currently, Wendy's has a substantial amount of cash on its balance sheet and low leverage, which will allow the company to finance further growth through the traditional mix of internal financing and borrowing.

As part of Wendy's long-term growth strategy, PAC Consulting recommends:

- **Evaluation of potential mergers, acquisitions, joint venture investments, alliances, vertical integration opportunities and divestitures**

  In 2001, the company formed a joint venture between Horton's and IAWS Group/Cuisine de France to build a par-baked goods manufacturing facility in Canada. In 2002, the company made several investments including a 45% minority ownership investment of $9.0 million in Cafe Express, a 25% minority ownership (fully diluted) investment of $12 million in Pasta Pomodoro and purchased 100% of the stock of Baja Fresh. In February 2004, the Company invested an additional $5.0 million to increase its ownership in Café Express to a 70% majority interest. Both Cafe Express and Pasta Pomodoro are fast-casual restaurant concepts. As the popularity of traditional fast food segments such as burgers, hot-dogs, etc. is decreasing, new themes such as Mexican food and casual salad/sandwich places provide opportunities for growth. Management should carefully evaluate their diversification strategy. Operating several different chains requires directing managerial efforts in a number of directions and necessitates a significantly more complex managerial structure, thus coordination becomes a challenge.

- **Leveraging the company's core assets**

  As part of the long-term growth strategy, Wendy's management is extremely focused on sales growth. Management should allocate resources to improve long-term return on assets and invested capital, and monitor its progress by tracking various metrics, including return on average assets, return on average equity and return on invested capital. Comparisons should also be made to historical performance, the company's peers and other leading companies, both on the corporate and individual store levels.

- **Growing average same-store sales**

  PAC Consulting believes that Wendy's success depends on providing everyday value, quality and variety, not price discounting. The company is making efforts in the right direction as the fast food industry rankings in the "Company Description" section show. Wendy's should continue to provide a variety of menu choices and to evaluate and introduce new products, such as low fat and low carbohydrate offerings, to meet the trends and desires of its customers. Furthermore, the company should reconsider its advertising strategy as Wendy's advertisings are currently missing a theme. The company should aim to deliver a balanced message of brand equity plus value in marketing. In addition, advertising and promotional activities at a local/restaurant level should improve same-store sales.

- **Improving store-level productivity to enhance margins**

  Wendy's should remain focused on established long-term operational strategies to enhance customer experience through improving speed of service, while maintaining the current levels of food quality.

Furthermore, the company should continue efforts to foster a performance-driven culture at a corporate as well as at a restaurant level – PAC Consulting suggests reevaluation of compensation plans by the management and reassessment of hiring policies by the human resources department.

- **Improving underperforming operations**

  While looking to improve sales and deliver 11-13% EPS growth in the long-term, the company should not neglect unprofitable ventures such as Baja Fresh. (Please refer to the previous section). Furthermore, management should continue reinvesting in its existing Wendy's restaurants to maintain a fresh image, providing convenience for its customers and increasing the overall efficiency of restaurant operations.

- **Developing profitable new restaurants**

  As all brands of Wendy's International are far from reaching saturation levels, the company should continue to add new stores. The location of the new stores is one of the key elements that will pre-determine Wendy's sales growth. The company should aim to allocate new stores in areas where the company has already established presence, but which are not overpopulated by fast food restaurants. The company has been making efforts in the right direction by working with Deloitte Consulting on developing new store locations.

The goal of these strategies is to increase average sales over time, primarily through greater customer traffic in the restaurants, while effectively managing corporate and field-level costs and controlling overall general and administrative expense growth.

Conclusion

Even though the company's main brand, Wendy's, is the third largest chain in the country, the company has managed to position itself as a leader in the fast food industry by maintaining one of the highest rankings (i.e. overall rankings as well as individual rankings for service, food quality, etc.) among its competitors and introducing constant innovations in the fast food market. Wendy's has been delivering a financially sound performance historically which is reflected in company's stock price, an all-time high of $40.00. In the short-term, the only significant challenge the company is facing is turning Baja Fresh into a profitable venture. In the long-term, the company needs to make some adjustments to its strategy in order to be able to achieve management's estimate of 11%-13% EPS growth.