Strategic Report for Jack in the Box Inc.

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Executive Summary

Jack in the Box Inc. began as a single hamburger restaurant off the highway in San Diego and developed into a massive company now operating over 2000 restaurants in 41 states. The company owns and operates Jack in the Box (the fifth largest fast hamburger chain), Qdoba Mexican Grill (one of the fastest growing quick-causal restaurants in the industry), and Quick Stuff convenience stores. Jack in the Box Inc. is a major player in the restaurant industry. This is an industry characterized by high competition and risk. Many companies that Jack in the Box Inc. competes with engage in strategic policies aimed at gaining market share. These include price competition, product differentiation, product promotions, and advertising. One of the most practiced and established strategies used to gain market share is to grow the company through franchising. Selling franchises is an effective way to pay for new restaurants and capture more of the market. Franchising is also an excellent way to overcome agency problems associated with owning and operating one's own stores. The franchisor- franchisee relationship aligns incentives between the company and its franchise owners by establishing mutual incentives to operate successful restaurants. It is evident that this is an effective strategy for chain restaurants as most companies are at least 75% franchised.

In recent years, Jack in the Box Inc.'s growth has slowed, causing the company stock to fall and trade at a discount relative to its peers. Pandora Group believes that some of this recent downturn is caused by the company's low degree of franchising. Another concern is the company's decision to embark on a rebranding strategy for Jack in the Box, while Qdoba should be the greater source of interest. In addition, Pandora Group's financial analysis reveals that the company's operating and profit margins are the lowest of its peers, indicating that the company's cost structure is inefficient. Pandora Group makes the following recommendations to improve the performance of Jack in the Box Inc.

First, Jack in the Box Inc. must pursue a rapid expansion policy fueled by franchising. Currently, the company is 25% franchised and hopes to be 35% franchised by 2008. We propose to increase the goal to 40-50% so the company can reap the benefits of the unique form of vertical integration. Secondly, Jack in the Box Inc. should abandon its decision to reposition Jack in the Box restaurants as the heart of its corporate strategy. The company is in year three of a five year plan to reinvent Jack in the Box. Not only is the company incurring high costs for implementing its strategy, the conversion of its Jack in the Box units from the fast-food sector into quick-casual dining is not being received well by customers. The third recommendation is that the company should place more emphasis on growing Qdoba. The fastest growth in the restaurant industry is seen in the quick-casual sector in which Qdoba operates. The restaurant has great increases in same store sales and therefore has the potential to be extremely profitable for the company if its growth is pursued. Lastly, the company's operating margins need to be improved through the reduction of the cost of goods. Jack in the Box Inc. is spending proportional to sales far more for goods than its competitors and is losing ground as a result. The following sections provide a more detailed analysis of the company and solutions to its problems.

Company Background

Jack in the Box Inc. is a publicly traded company that owns and operates Jack in the Box restaurants, Quick Stuff convenience stores, and Qdoba Mexican Grill restaurants across the country. Although its subsidiaries are a recent development, Jack in the Box has a vast history spanning the past 55 years. Growing from just one restaurant to thousands in 41 states across the US, Jack in the Box has used its impressive branding strategy and unique market staples to become a powerful national company today.

Jack in the Box started as a single fast-food hamburger restaurant in 1951, founded by Robert O. Peterson in San Diego. The restaurant was located on the freeway leading to the city, serving the hungry traveler. Although not the first restaurant of its kind, it differentiated itself in the market as the first fast-food restaurant to offer drive-thru window service. With "Jack", the family friendly clown, watching over the restaurant from the roof, 18 cent hamburgers, and an innovative drive-thru intercom system, the restaurant immediately became a success. At the time, Robert Peterson also operated a food-manufacturing facility for the San Diego Commissary Co. which changed its name to Foodmaker Co. in 1960. Under Foodmaker Co., more Jack in the Box restaurants were opened in Arizona and Texas thus making it a major West Coast competitor. In 1968, Ralston Purina Co. acquired Foodmaker and created over 1000 additional Jack in the Box restaurants all over the country. Several years later, 200 restaurants were closed in attempt to refocus on the Western and Southwestern markets. In 1985, an investment group completed a leveraged buyout of the company from Ralston Purina. Foodmaker then went public in 1987, but one year later reverted back to a private company. In 1992, Foodmaker decided to go public again. Over the next seven years, the firm realized its strongest component as Jack in the Box and relinquished control over all other parts of the company, changing its name and focus entirely to Jack in the Box Inc.

Jack in the Box is successful for its image and appealing menu. In fact, Jack in the Box is responsible for several staples in today's fast-food industry. Jack in the Box was the first to introduce the breakfast sandwich and portable salad which are standard menu items at all similar restaurants today. Flexibility is one of Jack in the Box's assets. Currently, Jack in the Box offers value meals for the price-conscious consumers and a "Build your Meal" section of the menu which entitles the customer to taper any meal to their liking. In addition, Jack in the Box concentrates on quality rather

than price. For example, when its fast-food competitors engaged in price wars in 2002, Jack in the Box chose not to compromise its high quality food and experience to compete, but rather to remain a consistent icon in the industry.

Jack in the Box has also developed one of the most famous brand images in the eyes of the consumer through "Jack" the clown. "Jack" has been used in advertising campaigns for the past ten years to become the all-time most successful running ad campaign in the industry. Through its witty use of "Jack" as the friendly CEO, the company's image is highly recognizable. As a result, over 21 million replicas of the oversized, happy face have been sold since 1995. All of these components are responsible for the company's past growth. In recent years, however, the company's growth has slowed and a rebranding strategy for Jack in the Box restaurants was launched. The company created a new version of the fast food chain, JBX Grill, which consists of higher prices, a more sit down feel, and a changed interior and exterior. The company recently ended it test of JBX as a stand alone restaurant, but is still avidly pursuing the rebranding of Jack in the Box restaurants.

In 2002, Jack in the Box developed a new concept in which a Jack in the Box restaurant would be placed with a convenience store called "Quick Stuff". The Quick Stuff locations are all co-branded with a highly recognizable full gas service station. The theory behind co-branding Jack's image is to "make sure a Sourdough Jack, a tank of unleaded, scratch tickets, bottled water, a trial-size box of detergent, French fries, transmission fluid, breath mints, etc"[i] can all be purchased in one sitting. Although this response from the Jack in the Box representative is slightly exaggerated, Quick Stuff's role as a traveling pit stop is an exciting addition to many of the Jack in the Box restaurants. Through the use of Quick Stuff convenience store locations, Jack in the Box Inc. was able to build restaurants in many locations that would have been too costly for just a "stand alone" restaurant.

Soon after, Jack in the Box Inc. wanted to make progress on its long-term goal of becoming a national restaurant company, so in 2003 the company acquired Qdoba Restaurant Corporation, the owner of Qdoba Mexican Grill. Qdoba Mexican Grill was named one of the Top 50 regional "Powerhouse Chains" of 2002 by Nation's Restaurant News. Qdoba has over 250 restaurants in 37 states, which allowed Jack in the Box Inc. to expand its territory to 41 states. Qdoba Mexican Grill is a fast growing quick-casual dining restaurant serving nouveau Mexican cuisine. Last year alone, Jack in the Box added 77 Qdoba restaurants to its inventory and plans to add around 90 this year.

Jack in the Box Inc. owns and operates the majority of the restaurants in its inventory, while the remainder are franchise operated. Jack in the Box restaurants are currently 25% franchise operated with the hope to become 35% franchise operated soon. Executives realize that the current company to franchise ratio (80-20) is capital and overhead intensive causing lower profits and returns to its shareholders[ii]. In response, the company is currently seeking partners to invest anywhere from 1 to 2 million dollars to operate their own restaurant. The company is willing to sell its current restaurants to franchisers as well as aid the development of new restaurants in up-and-coming locations. Jack in the Box has a vast network of support to assure that the transition to franchising is the easiest it can be. Although small compared to its major competitors such as McDonalds and Burger King, Jack in the Box Inc. is a force in the industry.

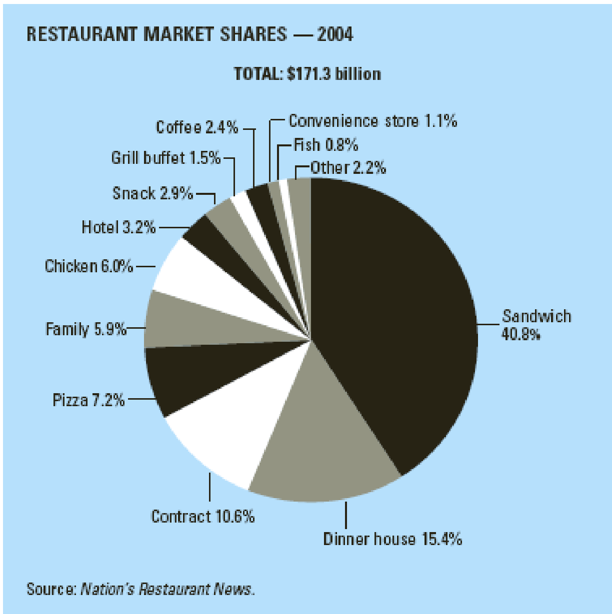
Competitive Analysis

Internal Rivalry

Jack in the Box Inc. is a dominant player in the restaurant industry. The industry is composed of three major segments: fast-food, quick-casual, and full service. Restaurants range from chain stores

to local diners, but the majority of this analysis will focus on the fast food and quick casual sectors in which Jack in the Box Inc. operates. Competitors that also fall into this category consist of chain restaurant powerhouses such as McDonalds, Yum brands, Burger King, Wendy's, Chipotle Mexican Grill, Panera Bread Company, and Quiznos Sub. These firms cover a large geographic market within the United States, but some are also international players. Jack in the Box Inc. is concentrated on the West Coast, primarily in California, thus limiting its geographic market area compared to some competitors. The restaurant industry has been rapidly growing over the years as less emphasis is placed on eating at home and more placed on finding substitutes for home-cooking. In fact, nearly 50% of total food expenditures are spent outside of the household every year, a number that continues to rise[iii]. Much of those expenditures are spent on restaurants that offer sandwiches (hamburgers). Jack in the Box is the fifth largest restaurant chain operating in the "sandwich sector" which has the largest market share in the restaurant industry as a whole (see figure 1).

Figure 1



The fast-food and quick-casual segments of the industry in which Jack in the Box Inc. operates are extremely competitive. This portion of the industry is characterized by high price competition that

results from the large number of sellers in the market and low switching costs of consumers. To gain or maintain market share in the industry, firms "employ strategies to improve consumer choice, convenience, and value. Techniques range from expanding cuisine types, discounting prices to attract customers, expanding takeout service, and using technology to improve customer satisfaction."[iv]

Jack in the Box Inc. purchased Qdoba Mexican Grill in 2003 to "expand its cuisine type" by successfully targeting the growing Latin American population. The company's initiative is well founded, considering four of the six fastest growing restaurants in 2004 are quick-casual eateries (Qdoba's segment) and the fastest growing restaurant is Chipotle Mexican Grill (a similarly themed restaurant to Qdoba).

Figure 2

FASTEST-GROWING US RESTAURANT CHAINS
(Ranked by percentage increase in number of units)

	FISCAL YR. END	% CHG. IN NO. OF UNITS	
		CURRENT YEAR	PREVIOUS YEAR
Chipotle Mexican Grill	Dec-04	44.6	43.2
Quiznos Sub	Sep-04	43.6	37.5
Buffalo Wild Wings Grill & Bar	Dec-04	40.1	29.5
Starbucks	Sep-04	30.9	25.1
Texas Roadhouse	Dec-04	30.0	15.1
Panera Bread Co.	Dec-04	28.1	32.0
P.F. Chang's China Bistro	Dec-04	25.7	26.4
The Cheesecake Factory	Dec-04	25.5	20.6
Red Robin Burgers & Spirits Emporium	Dec-04	25.3	15.2
Culver's Frozen Custard	Dec-04	23.2	22.5
Panda Express	Dec-04	22.5	17.8
LongHorn Steakhouse	Dec-04	18.7	16.9
Carrabba's Italian Grills	Dec-04	17.8	19.5
California Pizza Kitchen	Dec-04	16.6	16.3
Chili's Grill & Bar	Jun-05	14.8	11.8
CiCi's Pizza	Dec-04	14.2	13.9
Chick-fil-A	Dec-04	13.8	11.8
Del Taco	Dec-04	13.8	6.9
Dunkin' Donuts	Aug-04	13.6	10.2
Bojangles' Famous Chicken 'n Biscuits	Dec-04	13.5	7.1

Source: *Nation's Restaurant News.*

Fast food restaurants have also learned to set themselves apart by offering low prices. Pricing used to be the major tactic pursued by firms to gain market share. Restaurants would engage in price wars and discounting schemes, such as offering items for less than $1 or lowering the prices on certain items for a limited time. While this technique attracted customers, same-store sales and profitability suffered in the fast food sector.[v] Brand loyalty was also hurt by these pricing strategies because products are highly elastic, causing consumers to hop from restaurant to restaurant in search for deals. To improve brand loyalty and increase profitability, fast-food restaurants are now choosing to invest in product differentiation. This technique should raise prices slightly and create a greater demand for consumers to try out the new products. According to the National Restaurant Association, customers have responded well to new products, thus increasing sales growth and recovering operating margins from previously low levels.[vi] Jack in the Box recently opened an innovation center to focus on product inventions and differentiation initiatives.

Besides product offerings to stimulate sales, the newest trend in the industry is to multibrand. Companies are pursuing diversified portfolios by acquiring new companies. Jack in the Box Inc. acquired Qdoba and developed Quick Stuff convenience stores, McDonalds acquired Chipotle, Donato's Pizza, and Boston Market, and Yum Brands owns KFC, Taco Bell, and Pizza Hut. The reason to multibrand is that one company can serve a wider variety of customers thus capturing greater market share and maintaining growth. Multibranding has become so popular in the industry that 22 of the top 100 restaurant companies manage three or more restaurants.[vii]

Another important decision that faces the fast-food and quick-casual chain restaurant segments is franchising. Franchising is a unique vertical relationship between a franchisor and a franchisee. The type of franchise seen in the chain restaurant industry is a business-format franchise, in which the

franchisor provides a total system of doing business.[viii] The franchisee receives the benefit of buying into a successful business model, including industry know-how on pricing, location, accounting procedures, and advertising. In return the franchisee contractually agrees to operate the business with a standardized method required by the company. The relationship is unique because both parties have an incentive to run a successful business. A franchisee gets to keep a large portion of the profits and the franchisor gets to issue a fee dependent on the percentage of sales, so both parties have an incentive to ensure that the restaurant succeeds. There are some potential problems that can result from franchising, but they are mostly controlled by vertical restrictions. The main problem comes from the principal-agent relationship between the franchisor and the franchisee. The franchisor cannot observe each franchisee at all times, thus creating an incentive for the franchisee to free-ride or cheat. Free-riding can be such a great issue for the chain restaurant industry because the restaurants depend on a standardized product; if even one store lowers the quality of a product to save on costs, the entire company suffers in terms of the brand. To provide an incentive for restaurants not to free ride, the franchisor can limit the number of Jack in the Box restaurants nearby or allow the store to reap the benefits of nationwide advertising at a minimal cost. Franchising has been as important phenomenon in the fast-food restaurant as approximately 75% of restaurants are franchised. This allows for faster growth and greater market share. Jack in the Box only has 25% of its restaurants franchised and needs to accelerate its growth rate by adding more.

Entry

Barriers to entry in the restaurant industry are relatively low. Seven out of every ten restaurants are run by small-scale entrepreneurs, but those restaurants are usually unique and local rather than a competitor to Jack in the Box Inc. Entry into the restaurant industry is appealing for its potential profitability and ease of entry, but is also extremely risky due to high levels of competition and frequency of failure. Entry into the fast food and quick casual sectors, however, is much more

restricted than the restaurant industry as a whole because a handful of restaurants control almost the entire market. For example, the 33 top chain restaurants produced sales of $119.2 billion in 2004, which constituted 70% of total industry sales[ix]. To compete against Jack in the Box, McDonalds, and Burger King, one must also compete with the vast economies of scale, industry know-how, brand image, high capital costs, purchasing power, and pricing strategies enlisted by these companies. Most chain restaurants have already established a cost efficient means of production, powerful brand name, years of advertising and market research experience, and have the financial means to dictate pricing in the market. These chain restaurants have been gathering market share from small operators by expanding rapidly. By adding additional restaurants and simply holding all the best real estate, these companies make competition extremely intense. Although not impossible to create a new restaurant, the best strategy in the already saturated market to which Jack in the Box Inc. belongs, is to franchise your very own fast food powerhouse.

Substitutes and Complements

Substitutes are a major force in the restaurant industry because most goods offered in the fast-food and quick casual sectors are extremely elastic. Customers are price sensitive and have low switching costs, causing other restaurants in the industry to be the most threatening substitutes. These companies understand consumer behavior and invest a great deal in advertising, product promotions, pricing strategies, and product differentiation to compete for market share. The segment of the market that Jack in the Box Inc. competes in serves the customer that is looking for something quick and cheap. If the customer is looking for something other than fast-food, then sit-down restaurants, convenience stores, and supermarkets become the most likely substitutes.

One advantage that fast-food restaurants and other chains have in the industry is their recognizable brand and standardized products. It seems that McDonald’s trademark yellow and red emblem

ignites an impulse value larger than the actual utility preferences between restaurants; that is customers like the guarantee and frequency of a good meal that McDonalds provides. The large chain model, that McDonalds and others use, has been recognized as so successful in the industry that many other large scale companies in the quick-casual sectors are copying it. These restaurants are rapidly expanding to reap the benefits of scale, increased purchasing power, and customer satisfaction testing.[x] For example, Applebee's International has opened more than 100 stores in the past 12 years. This poses are great threat to Jack in the Box Inc. because as more restaurants become well known, Jack in the Box Inc. looses its brand advantage.

Lastly, home cooking it still a viable option for many customers as over 50% of meals are eaten in the home.[xi] There seems to be movement away from the fast-food sector as a good alternative to home cooking because of recent health concerns. In the past several years the fast-food industry has dealt with lawsuits claiming that certain companies are responsible for obesity-related health issues of customers. While there has been movement to make menus with more nutritional products, Americans are swept up in a more health-conscience culture. Most restaurants have a health-conscience portion of their menus to keep people eating away from the home, but perhaps we will begin to see a slow down in the rate that Americans prefer to eat out.

Major complements for the fast food and quick casual industries are shopping centers, gas stations, and other high traffic areas. Jack in the Box Inc., for example, owns a large selection of convenience stores that are paired with a Jack in the Box restaurant and a national fuel station. The idea is to create a one-stop-shop for the traveling customer and to share fixed costs. This is a technique used by many of the fast food chains that have invested in diversified portfolios. For example, Yum Brands believes its sites that incorporate a KFC, Pizza Hut, and Taco Bell into one restaurant achieve 20-30%

greater sales than a stand alone restaurant.[xii] Multibranding is one of the most significant complements in the industry because it provides more choices to a fickle customer.

Supplier Power

Supplier power does not seem to be a great force in the industry, especially for large-scale chain restaurants. Food and beverages are the second most costly inputs for restaurants besides the labor supply. The companies tend to negotiate directly with national and regional suppliers to get the best products for the best prices. The larger the company, the less power a supplier has because the, "supply contracts signed by larger chains can lock in less volatile food products, like beef, at stable prices for an entire year."[xiii] Most companies use this hedging strategy to ensure a steady supply of a product at a given price. Although input prices have been increasing over the past several years, suppliers are still offering the market price. Suppliers, especially for companies like Jack in the Box Inc., cannot extract profits by demanding above market prices. The increase in prices is strictly due to events such as mad cow disease outbreaks that interrupt the flow of some inputs, thus causing higher prices. Suppliers, however, are not controlling these fluctuations.

Supplier power is also extremely low for laborers in the fast-food industry. The vast majority of workers are aged sixteen to twenty-four, work part time, and have low levels of education and skill. Because of these characteristics, and the lack of unionization among workers, wages remain low. Worker turnover is great indicating that while retention is difficult, replacing workers is relatively easy and their power is low.

Buyer Power

Buyer power "refers to the ability of individual customers to negotiate purchase prices that extract profits from sellers."[xiv] Under this definition, buyer power in the industry is relatively low because

individual customers have low purchasing volume and are not very concentrated. On the other hand, buyers in the fast-food sector have low switching costs that have induced restaurants to use heavy discounting schemes to attract customers. This tactic did erode profits in the industry and is not used as much today, but “swing” customers that have little brand loyalty are always a threat to low priced restaurants. Other options, however, like home cooking or sit-down restaurants are not feasible alternatives for the customer that wants a cheap, quick meal. For this reason, restaurants like Jack in the Box and Qdoba have the power to dictate prices within a reasonable range. In addition to customers, franchisees have little buyer power because they must fulfill all of the requirements the companies set for them in long term contracts.

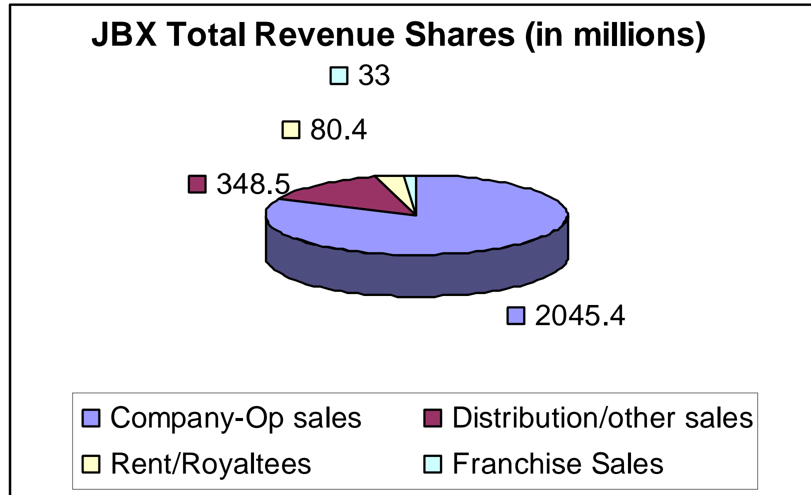
Financial Analysis

Revenues

Jack in the Box Inc. operates two major restaurants and one store in the restaurant industry: Jack in the Box, Qdoba Mexican Gill, and Quick Stuff Convenience stores. Jack in the Box comprises the largest portion of the company, thus generating the greatest revenue; however, it is not necessarily the fast growing component. In 2005, Jack in the Box Inc. reported total revenues of $2.5 billion and net income of $91,537 million. Reported revenues increased due to company-operated restaurants sales, other distribution and sales, franchise rents and royalties, and from the selling of company-operated restaurants to franchisers. More specifically, company-operated restaurant sales increased to $2,045.4 million in 2005 from $2,033.5 million in 2004. This growth can be attributed in part to a 2.4% and 11.8% increase in same-store sales for Jack in the Box and Qdoba restaurants respectively. Distribution and other sales nearly doubled in 2005 to $348.5 million. These sales increased from the addition of new restaurants and convenience stores, as well as from the addition of franchised restaurants. The steady growth of franchised restaurants also attributed to the $14 million gained in revenue from franchise royalties and rents. Lastly, Jack in the Box Inc. made

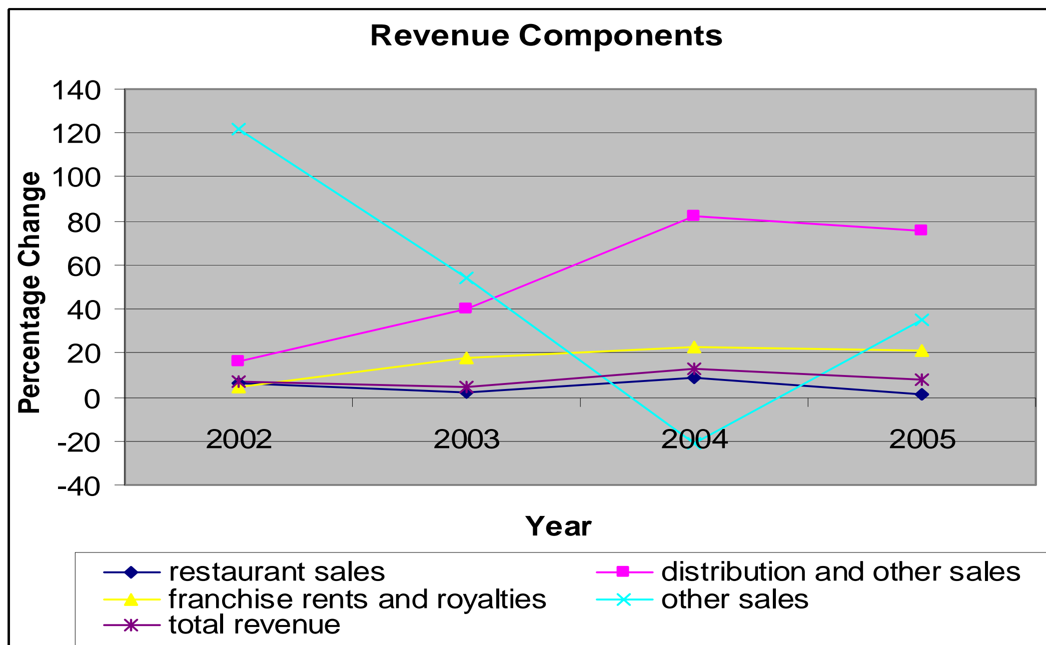
progress in its goal to sell off more of the currently company-owned restaurants to franchisees and achieved $33 million from those sales[xv] (see figure 3).

Figure 3: Revenue Components in 2005



Although theses numbers appear to be increasing, when combined, total revenue has actually been increasing at a decreasing rate in the last five years (see figure 4).

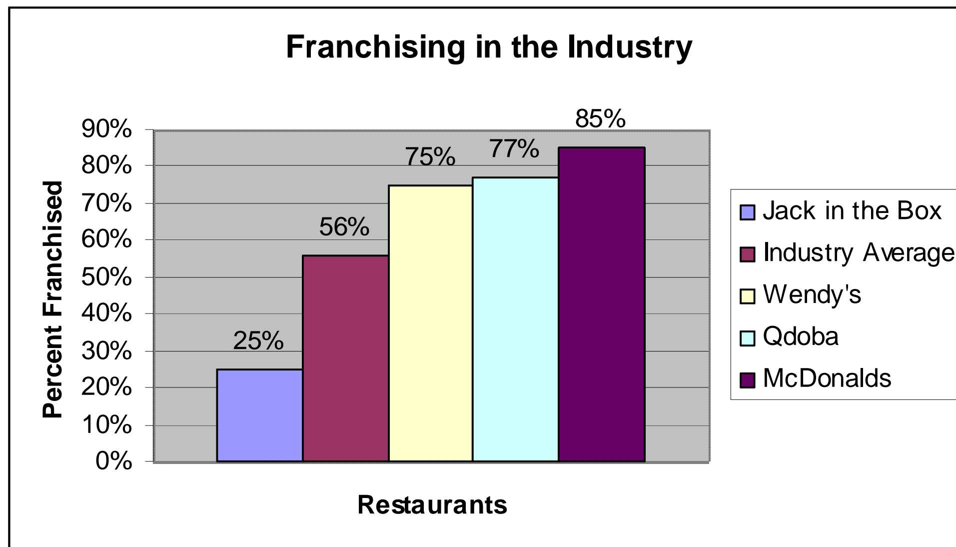
Figure 4: Revenue Growth



The decline in revenue growth indicates that Jack in the Box is experiencing a period of slow overall growth. Figure 4 shows that the segment of revenue declining the most is sales generated from company-operated stores which is most likely due to a lack of franchising, an unsuccessful re-branding strategy, and higher prices and costs.

Seventy-five percent of Jack in the Box restaurants are company-operated, and sales growth within those stores increased 2.4% in 2005 compared to 4.6% in 2004 (an obvious reduction). Qdoba restaurants, on the other hand, had same-store sales increases of 11.8% in 2005 compared to 9.3% in 2004. It appears that Qdoba is growing much faster than Jack in the Box, yet the company is devoting most of its effort into its five year plan to reposition Jack in the Box. Part of the reason why Qdoba and other restaurants are growing much faster than Jack in the Box is because the restaurant's counterparts are highly franchised in comparison to Jack in the Box. Jack in the Box is only 25% franchised, whereas, Qdoba and its major competitors are over 75% franchised (see figure 5).

Figure 5: Franchising Comparison in 2005



If Jack in the Box Inc. wants to compete on the same level as McDonalds, Burger King, and Wendy's, the percentage of franchised restaurants should not be three times lower than its average competitor.

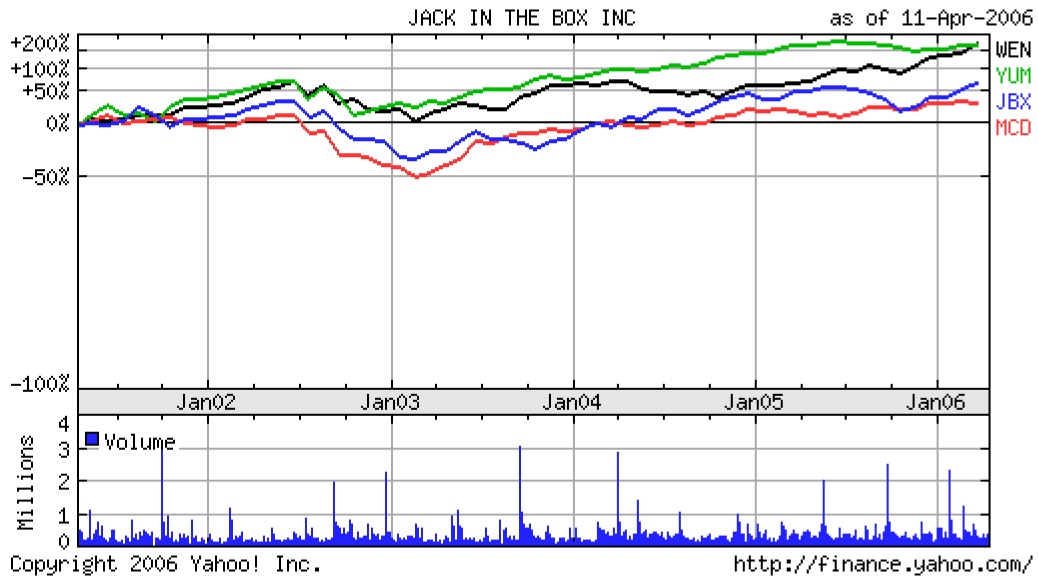
Costs

Not only are Jack in the Box Inc.'s revenues tapering, costs are simultaneously increasing. Restaurant cost of sales increased to $646.7 million in 2005 from $630.9 million in 2004. Costs have increased mainly because of food and packaging costs. For example, the cost of beef rose 11% and the costs of produce rose 9% in 2005.[xvi] In fact, the only element of costs that did not increase was restaurant operating costs which Jack in the Box Inc. attributes to "Profit Improvement Program" initiatives designed to improve labor management. To offset some of the costs, Jack in the Box is slowly raising menu prices by offering a differentiated product. For example, when Jack in the Box launched its JBX Grill idea, the classic Jumbo Jack sold for $2.95 at JBX versus $1.29 at regular Jack in the Box restaurants. Most other menu items increased in price by at least ten cents.[xvii] Jack in the Box recently ended its test of JBX Grill as a stand alone restaurant because the consumers did not accept the idea as had been hoped.[xviii] The failure of JBX Grill may have been due to the higher costs in a value-conscious market.

Stock Price and Dupont Analysis

Jack in the Box's stock price has slightly out performed the S&P500, but JBX is currently trading at a discount to most of its peers (see figure 6)[xix].

Figure 6: JBX Stock Price over time Compared to Competitors



JBX is trading at a discount because of rising costs, unpopular menu innovations, and its market repositioning strategy.[xx] Even more indicative of Jack in the Box's slow down is its current revenue growth and long term growth rate projected to be 0.11% and 10.0% respectively. Compared to industry leaders, Jack in the Box is lagging behind (see table 1).

Table 1: Comparison of Industry Statistics – JBX. vs. Industry Leader

Statistic	Company	Value	JBX
Market Capitalization	McDonalds	43.69B	1.49B
P/E Ratio (ttm)	Rick's Cabaret	76.45	17.27
PEG Ratio (ttm, 5 yr expected)	Chipotle	3.12	1.65
Revenue Growth (Qtrly YoY)	Triarc	1.80%	0.11%
EPS Growth (Qtrly YoY)	Brazil Fast Food	6.53%	0.03%
Long-Term Growth Rate (5 yr)	BJ's Restaurants	34.50%	10.00%
Return on Equity (ttm)	Noble Roman's	67.66%	16.37%
Long-Term Debt/Equity (mrq)	Meritage Hospitality Group	3.373	0.538
Dividend Yield (annual)	Star Buffet	7.10%	N/A

The restaurant industry, especially the chain restaurant segment, is so competitive that a leading revenue growth of 1.8% implies that the market is quite saturated and it is extremely hard to gain market share. Jack in the Box Inc. is trying to remain competitive by re-branding and offering innovative products, but sales growth is still declining, indicating that something is not working.

The Dupont Analysis for Jack in the Box Inc. reveals some of the company's weak areas in comparison to its competitors. The following table shows the components of Jack in the Box Inc.'s ROE.

Table 2: Dupont Analysis Results

Profitability	Turnover	Solvency	ROE
3.60%	1.88x	2.37x	16.37

After comparing profitability, turnover, and solvency to JBX's competitors, it appears that the company has an especially weak profitability component of its ROE. The comparison of company margins exposes JBX's weakness (see table 3).

Table 3: A comparison of Margins

	JBX	McDonalds	Yum Brands	Wendy's	Average
profit margin	3.53	12.72	8.5	5.92	7.6675
ROE	16.37	17.73	50.07	11.87	24.01
total operating expenses	2369.03	4299.1	2566	923.95	539.52
selling/general operations	273.82	615.6	383	98.75	342.793
operating margin	6.23	20.06	12.02	10.98	12.3225

Table 3 shows that Jack in the Box has a profit margin of 3.53% which is well below that of its competitors. By breaking profitability down into taxes, financing, and operations, it is evident that Jack in the Box Inc. is lacking in operations.

Table 4: Disaggregation of ROE

Taxes	Financing	Operations
34%	0.889	6.17%

The company's operating margin is well below that of its competitors indicating that the cost structure is one area that requires further analysis. Jack in the Box's total operating expenses are relatively in sync with its competitors, so perhaps the company is not getting as much out of operations as the other companies.

Looking at stock multiples for JBX and its competitors show further evidence that JBX is trading at a slight discount to its peers (see table 5)[xxi].

Table 5: Multiple Comparisons to Major Competitors

	JBX	McDonalds	Yum Brands	Wendy's	Average
Trailing P/E (ttm, intraday):	17.27	16.99	19.08	32.81	21.5375
Enterprise Value/EBITDA (ttm)[3]:	6.952	9.117	9.193	12.232	9.3735
Price/Book (mrq):	2.68	2.88	9.36	3.72	4.66
Price/Sales (ttm):	0.57	2.12	1.44	1.96	1.5225

As shown in table 3, each of Jack in the Box Inc.'s multiples are lower than its major competitors beside the trailing P/E of McDonalds. Jack in the Box Inc. needs to resolve its sales difficulties and declining growth problems in order for the stock to have multiple expansion.

Strategic Issues and Recommendations

Franchising

Jack in the Box Inc. operates fewer restaurants, in fewer areas, than most of its major competitors (see figure below)[xxii].

Table 6: Number of Restaurants and Operating Countries

	Total Restaurants	Operating countries
JBX	2,049	1
McDonalds	31,886	100
YUM	34,000	100
Wendy's	9,900	2+ undefined international
Burger King	11,100	65

The company also has one of the lower long term expected growth rates of its competitors (10% compared to 11% and 12% of Wendy's and Yum Brands)[xxiii]. All of these signs, along with the fact that Jack in the Box is trading at a discount to its peers, indicate that the company needs to accelerate its growth. A successful strategy to ensure long term growth, as well as achieve rapid growth, is to franchise. As seen in figure 3 above, the company has over 50% fewer franchised restaurants than its peers which is reflected in the number of currently operating restaurants. Jack in the Box Inc. is not unaware of its need to franchise and has set a goal to have 35% of it restaurants franchised by 2008. For example, the company reported in its 10K, "To improve margins and returns on capital over time, our business model includes increasing the use of franchising as we grow the Company." Pandora

Consulting believes that while this is a good goal, the company will gain more from raising its goal to 40-50% by 2008. Jack in the Box Inc. must actively pursue the sale of company-operated restaurants to franchisees and the building of new restaurants by franchisees. This goal also applies to Qdoba restaurants as well as the Quick stuff convenience stores.

Franchising provides a mutual benefit to the company and the franchisee by aligning their interests to operate a successful store. Franchising will allow the company to expand their brand name without bearing all of the costs acquiring land, buildings, and equipment.[xxiv] The franchisee buys into a successful business model with much of the dirty work is done for them. To own a Jack in the Box, the franchisee must pay an initial franchise fee of $50,000 along with royalty payments and marketing fees of 5% of gross sales. Qdoba franchises have an initial fee of $25,000 and slightly lower annual fees. These payments, however, give the company a steady stream of income to invest elsewhere and provide an incentive for both parties to ensure the restaurant's success. These fees, however, may also be part of the reason for Jack in the Box's low franchising. For example, the initial fee to own a Yum Brands store, Subway, or Quiznos restaurant is well below $50,000.[xxv] Perhaps Jack in the Box Inc. wants to ensure that the franchisee is financially strong due to poor principal-agent relationships in the past, but the high fee may be acting as a deterrent to capable investors who are choosing to own a cheaper store elsewhere. We recommend lowering the initial fee to encourage more rapid growth. This does not mean franchising to unqualified people, it means mirroring the successful business model instituted by many existing chain restaurants.

Give up on JBX already!

Jack in the Box Inc. is in year three of a five year plan to reinvent the Jack in the Box brand. The company feels that it cannot compete long term with its competitors in pricing because they have much less financial flexibility. Although the industry has turned away from direct price competition,

Jack in the Box Inc. feels that its only way to survive is to offer a unique menu with differentiated products of higher quality. The company launched a series of JBX Grill prototypes for their reinvention strategy. With higher prices than normal for fast food, the restaurants were not a great success. Jack in the Box restaurants are well known in the fast food industry and moving into the quick-causal sector is too difficult. The company ended its test of JBX Grill as a stand alone restaurant, but still wishes to use what it learned from the test on all current Jack in the Box restaurants. Pandora Consulting believes that this is a waste of time and money because customers in the fast food industry are largely dependent on value. Price increases are not likely to be accepted by customers and the brand image of Jack in the Box may be hurt. We recommend continuing to differentiate the menu, but to strengthen rather than change the brand image of Jack in the Box. This can be achieved by better advertising and more robust testing of new products to ensure that customers will like them before they are launched. With more restaurants through franchising and a greater market area, a solid advertising campaign will significantly improve the brand recognition of Jack in the Box.

What about Qdoba?

Jack in the Box restaurants achieved a 2.4% increase in same store sales last year which was down from previous years, while Qdoba achieved an 11.8% increase, a figure up from previous years. Qdoba is operating in the quick-causal sector of the restaurant industry, and is among the fastest growing restaurants in the industry. Instead of transitioning Jack in the Box into JBX Grill (or a similar concept), the company should actively pursue growth of Qdoba restaurants. Qdoba is doing extremely well, but the company is too focused on its five year plan of Jack in the Box to notice. More energy should be spent on trying to expand the number of Qdoba restaurants to compete with its competitors Chipotle and Baja Fresh. Qdoba restaurants can be found in 37 states, but there are only 250 total restaurants. They spread thin in comparison to Jack in the Box restaurants where around

2000 restaurants are in less than 5 states. We recommend adding Qdoba restaurants in the areas that are the most successful, so that a solid brand can be achieved. By moving away from the reliance on Jack in the Box as the heart of the company, long term growth may improve.

Watch out for the margins

Jack in the Box Inc. has lower profit and operating margins than many of its main competitors, as indicated in the margin comparison above (see table 3). The higher profit margins of Jack in the Box Inc.'s competitors indicate that those companies have better control over their costs. For example, Jack in the Box Inc. is only receiving a net income of 3.5 cents for every dollar of sales, whereas the average company in the comparison is netting 7.7 cents for each dollar. The company's operating margins are also much lower than its competitors, indicating that variable costs must be extremely high. By comparing the income statements of Jack in the Box Inc. to its competitors, it is clear that Jack in the Box Inc. is spending too much on goods.[xxvi] The table below shows that the percentage of revenue spent on SGA is comparable to the competitors, but the company is spending at least 7% more of its revenue on goods than other companies (see table 4).

Table 4: Percentage of Revenue Spent of Cost of Goods

Cost of Goods:

	2005	2004	2003
JBX	83%	82%	82%
YUM	76%	52%	76%
MCD	69%	45%	70%
WEN	76%	75%	73%

SGA:

	2005	2004	2003
JBX	11%	11%	11%
YUM	13%	37%	11%
MCD	11%	35%	12%
WEN	8%	8%	8%

From these figures, it is clear that the company needs to reduce the cost of goods. In the 10K, Jack in the Box Inc. breaks down cost of goods into four categories: restaurant costs of sales, restaurant operating costs, costs of distribution and other sales, and franchised restaurant costs. It appears that

revenue generated from distribution and other sales has been increasing in the last few years, but 98% of that revenue is being spent on the distribution costs itself.[xxvii] The company should not pursue growth of sales from distribution if they are receiving minimal profits from that venture. The company reports that distribution costs and other sales costs have increased due to higher fuel prices at Quick Stuff fuel locations. We argue that distribution costs may decrease with the rapid expansion of the company restaurants through franchising. Perhaps greater scale economies in distribution can be achieved, with increased profits as a result. In the meantime, costs of goods must be reduced. Operating margins should improve as revenue spent on goods reaches a level similar to the company's competitors.

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