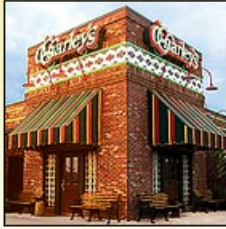


# O'CHARLEY'S INC.



**O'Charley's**  
GOOD FOOD AND GOOD TIMES  
START WITH O'.



**99 Ninety Nine**  
Restaurant & Pub  
You'll Always Come Back For More™



**Stoney River**  
LEGENDARY STEAKS.

ACC712 Final Project

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## **Introduction**

O'Charley's, Inc. owns and operates casual dining restaurants within the Midwest and Eastern regions of the United States. O'Charley's, Inc. acquired its first restaurant in 1984 and has since grown to operate 326 restaurants. These restaurants are divided into the following major chains:

### *O'Charley's – 221 locations*

OC primarily targets mainstream casual dining customers by offering a variety of freshly made high quality entrées for an affordable price. The average customer check, including beverages, was \$11.52 in 2004, \$11.60 in 2003, and \$11.59 in 2002. 15% to 20% historical growth has been achieved through opening new stores each year. More recently, franchising is being utilized to expand into new regions of the United States. 12 to 15 new locations are planned to open in 2005.

### *Ninety Nine Restaurant and Pub – 99 locations*

NNRP primarily targets mainstream casual dining and value-oriented customers by offering a large 75 item menu. The average customer check, including beverages, was \$13.86 in 2004 and \$13.78 in 2003. Ninety Nine restaurants have approximately two-thirds of the seating capacity of O'Charley's. NNRP was acquired by O'Charley's in 2003. Growth has been achieved primarily through remodeling traditional and non-traditional locations. 13 to 15 new locations are planned to open in 2005.

### *Stoney River Legendary Steaks – 6 locations*

SRLS Primarily targets upscale and fine dining customers by offering high-quality food and attentive customer service typical of high-end steakhouses, but at more moderate prices. The average customer check, including beverages, was \$39.53 in 2004 and \$37.42 in 2003. SLRS was acquired by O'Charley's in 1999. Two additional restaurant openings are planned in 2005.

## **Business Strategy**

### *Company*

O'Charley's, Inc.'s growth is largely dependent upon its ability to expand. Acquisitions and new store openings have kept historical growth rates above 15%. Looking forward, O'Charley's plans to increase its franchising program to expand into new regions of the United States. Currently there are plans to open 35 new franchised O'Charley's locations in 2005. O'Charley's seeks to utilize the following strategies to continue its growth and success:

- Protect the culture and individuality of each restaurant
- Provide an attractive price to value relationship
- Pursue a disciplined growth strategy
- Cluster new restaurants to enhance supervisory and distribution facilities
- Leverage the commissary operations
- Provide an attractive operating environment for employees

### *Macroeconomic Trends*

Economists forecast economic growth in 2005 at 3.6 percent on expectations for strong consumption. The United States grew approximately 4.4 percent in 2004, its biggest annual gain since 1999. Forecasters also saw a slight increase in inflation (2.3%) and short-term interest rates during 2005. To fight inflation and excess liquidity, the Federal Reserve has increased the federal funds rate 1.5 percentage points since

last June. Nonfarm US Payrolls are expected to expand at 175,000 per month. These forecasts are indicative of an expansion year in 2005 for the US economy, which bodes well for the restaurant industry<sup>1</sup>.

Given the current forecast for macroeconomic conditions, O’Charley’s is well suited to take advantage of a US economic expansion cycle. Without an anticipated economic recession and given the historical growth of the restaurant industry, there is no reason to believe that O’Charley’s will not be able to sustain its current level of profitability. However, if economic conditions worsen, or social trends put the restaurant industry out of favor, O’Charley’s future profitability will be negatively impacted.

### Industry Overview

While the restaurant industry is characterized as a mature industry it continues to grow at a decent rate each year. Since 1970, restaurant sales have been rising approximately 5% a year (figure 1) and the industry has seen 13 consecutive years of real growth (figure 2). With more than 900,000 restaurants in operation, the U.S. restaurant industry can be described as fragmented and extremely competitive due to the broad product differentiation, service levels, and regional operations. The industry has two major segments: full-service or fast food.

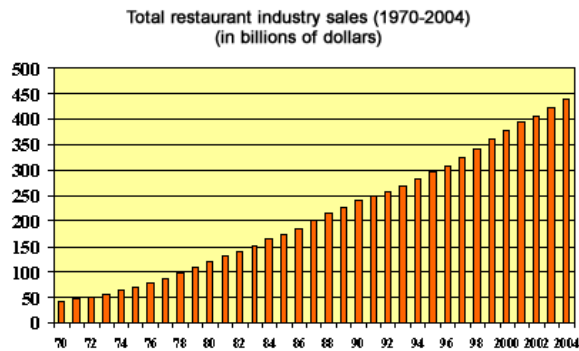


Figure 1: Sales

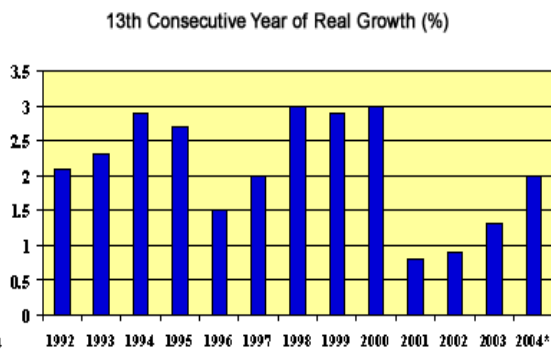


Figure 2: Real Growth

Source: National Restaurant Association 2004 Industry Forecast

The restaurant industry is extremely sensitive to changes in the economy, lifestyle trends, and seasonality (customer spending patterns at restaurants are generally highest in the first quarter and lowest in the third quarter of the year).<sup>2</sup> Restaurant sales have a high correlation with the health of the U.S. economy as well as household disposable income. In 2005, restaurant-industry sales are forecasted to rise 4.9% and equal 4% of the U.S. gross domestic product.<sup>3</sup> Currently, the lifestyle trends that are having the largest affect on the restaurant industry are health and convenience. As Americans are trying to live healthier lifestyles, more restaurants are including low-fat, low-carb, and heart healthy menu options. In addition, as Americans are working longer hours and the number of dual-income households is increasing, people have less time to prepare meals at home and therefore are choosing to dine-out or to order takeout. According to the NPD Group, takeout occasions represented 51 percent of all foodservice occasions in 1999, up from 46 percent in 1990. The Chicago-based consulting firm Technomic Inc. projects that between 1997 and 2007 takeout sales will grow from \$126 billion to \$195 billion.<sup>4</sup>

<sup>1</sup> All figures published by the Federal Reserve Bank of Philadelphia,

<sup>2</sup> Outback Steakhouse March 16, 2005 10-K

<sup>3</sup> <http://www.restaurant.org/pdfs/research/2005factsheet.pdf>

<sup>4</sup> <http://www.restaurant.org/rusa/magArticle.cfm?ArticleID=407>

Restaurant operators face many challenges in an extremely competitive industry plagued with low profit margins. These major challenges include a shrinking labor force, rising commodity prices, increasing government food regulations, and the recent economic slowdown. Given these challenges and the large cost to build new units, it is expected that future growth for restaurant companies will be achieved through acquisition. Acquisitions give restaurant companies a larger revenue base over which to spread costs, and it also gives them more leverage with suppliers to keep costs down.<sup>5</sup>

## Accounting Analysis

### *Rent Holidays*

On March 4, 2005, O'Charley's announced that changes in lease accounting principles would delay the issuance of its 10-K report. These changes came as a result of the SEC's elimination of the "rent holiday," a term which refers to the point from which land becomes available for construction to the point at which rent payments begin. On February 7, 2005, O'Charley's changed its policy for lease accounting to be in accordance with GAAP: rent is now recognized on a straight-line basis from the time the company commits to leasing a property. As a result, the 2002 and 2003 financial statements were restated to reflect these changes.

Tables 1 – 3 summarize the impacts of these restatements. These changes led to a restatement of the accounting for operating leases, decreasing retained earnings on the balance sheet and net earnings on the income statement. The 2003 change in net earnings is too small to change earnings per share; however, in 2002, earnings per share dropped \$.03 (basic) and \$.02 (diluted).

**Table 1- Impact on Earnings**

	Retained earnings	Increase (decrease) in net earnings	
		2003	2002
<b>As previously reported</b>	135,997	21,273	20,668
Restatement items:			
Accounting for Operating Leases	(4,861)	(842)	(800)
Cost and Profit Recognition on Inventory	(467)	(76)	(61)
Total Pretax Impact	(5,328)	(918)	(861)
Tax calculation errors	424	424	
Impact of restatement on tax provision and deferred taxes	1,956	410	326
Total restatement items	(2,948)	(84)	(535)
<b>As restated</b>	133,049	21,189	20,133

*(Retained earnings shown at the end of FY2003. Dollars in thousands)*

**Table 2- Impact on Income Statement**

Selected Income Statement Data: (in thousands of dollars)	Fiscal Year Ended 2003			Fiscal Year Ended 2002		
	As previously reported	As restated	Change	As previously reported	As restated	Change
Cost of food and beverage	\$ 221,129	\$ 221,206	\$ 77	\$ 140,577	\$ 140,638	\$ 61
Restaurant operating costs	\$ 138,473	\$ 139,205	\$ 732	\$ 85,761	\$ 86,006	\$ 245
Preopening costs	\$ 6,337	\$ 6,900	\$ 563	\$ 5,074	\$ 5,629	\$ 555
Total costs and expenses	\$ 712,341	\$ 713,260	\$ 919	\$ 453,415	\$ 454,276	\$ 861

Total pretax impact on net earnings is examined in more detail in table 2. As expected, pre-opening costs increased due to the elimination of the rent holiday.

<sup>5</sup> [http://biz.yahoo.com/ic/profile/eating\\_1442.html](http://biz.yahoo.com/ic/profile/eating_1442.html)

This accounting change led to a total increase of just \$438,000 on both sides of the balance sheet; however, an increase of \$6.8M in other liabilities was offset by decreases in retained earnings, deferred taxes, and total current liabilities.

**Table 3- Impact on Balance Sheet**

<b>Selected Balance Sheet Data (at end of FY2003):</b>	<b>As previously reported</b>	<b>As restated</b>	<b>Change</b>
Inventories	\$ 21,980	\$ 21,513	\$ (467)
Total current assets	\$ 49,504	\$ 49,037	\$ (467)
Property and Equipment, net	\$ 429,361	\$ 430,266	\$ 905
Total Assets	\$ 620,235	\$ 620,673	\$ 438
Federal, state and local taxes	\$ 8,836	\$ 8,359	\$ (477)
Total Current Liabilities	\$ 80,810	\$ 79,321	\$ (1,489)
Deferred Income Taxes	\$ 6,940	\$ 5,037	\$ (1,903)
Other Liabilities	\$ 29,752	\$ 36,530	\$ 6,778
Total Liabilities	\$ 317,100	\$ 320,486	\$ 3,386
Retained earnings	\$ 135,997	\$ 133,049	\$ (2,948)
Total shareholders equity	\$ 303,135	\$ 300,187	\$ (2,948)
Total Liabilities and Shareholders Equity	\$ 620,235	\$ 620,673	\$ 438

### ***Sales and Leaseback***

In 2003 and 2004, O'Charley's sold 34 properties to a non-related entity, for approximately \$71.2M. All of these properties were then leased back to O'Charley's, resulting in annual lease expenses of approximately \$4.9M annually, and the elimination of approximately \$1.4M of depreciation. In addition, the company is amortizing a \$21.4M deferred gain over a 20-year period. This change in strategy will increase the company's lease expenses, while decreasing PP&E, depreciation, and interest expense. The obligation on these leases is varied, with expiration dates ranging over the next 20 years.

### ***Interest Expense***

Interest expense decreased during 2004 because proceeds from the sales and leaseback transactions were used to pay some of O'Charley's revolving credit obligations. In addition, the company had been carrying \$125M in senior subordinated notes at a fixed rate of 9%. This portion of interest expense should decrease in 2005 because \$100M of these notes has been converted through a rate swap into a variable rate of the six-month LIBOR in arrears + 3.9%.

## **Financial Analysis**

See Table 4 below for a summary of a ratio analysis of O'Charley's against comparable firms Applebee's, Brinker International, Darden Restaurants, and Ruby Tuesday. Comparable firms were chosen due to their similar menu choices, moderate pricing, and casual dining styles. Like O'Charley's, Brinker International and Darden Restaurants also own a portfolio of restaurants.<sup>6</sup>

**Table 4**

	<b>O'Charley's</b>	<b>Applebee's</b>	<b>Brinker International</b>	<b>Darden Restaurants</b>	<b>Ruby Tuesday</b>
	<b>Profitability Ratios</b>				
Gross Margin	18.6%	24.5%	17.5%	22.1%	58.3%
Net Profit Margin	2.7%	10.0%	4.1%	4.6%	10.6%

<sup>6</sup> Brinker International owns Chili's, Romano's Macaroni Grill, Maggiano's Little Italy, On the Border, Corner Bakery & Café, Big Bowl, Rockfish seafood grill. Darden Restaurants own Red Lobster, Olive Garden, Bahama Breeze, Smoky Bones Barbeque and Grill, Seasons 52.

Return on Equity	7.4%	23.2%	14.0%	19.0%	23.4%
Return on Net Operating Assets	6.4%	22.1%	10.0%	13.9%	17.1%
	<b>Turnover Analysis</b>				
Net Operating Asset Turnover	1.684	2.195	2.332	2.656	1.581
Net Working Capital Turnover	(44.019)	(19.616)	(85.963)	(15.710)	(34.790)
	<b>Leverage Ratios</b>				
Debt to Equity Ratio	0.578	0.072	0.651	0.536	0.320
Current Ratio	0.675	0.664	1.057	0.507	0.659
Quick Ratio	0.205	0.347	0.698	0.098	0.325
EBIT Interest Coverage	3.434	101.648	21.233	9.747	45.257
Financial Leverage (LEV)	0.632	0.059	0.478	0.543	0.400
	<b>Valuation Ratios</b>				
P/E	25.32	21.33	28.95	19.55	15.86
P/B	1.56	4.68	3.45	3.76	3.08

### ***Profitability***

O'Charley's profitability measures are low compared to the industry. O'Charley's has a return on equity that is much lower than comparable firms. According to the Advanced Dupont Model, this discrepancy can be attributed to both the low return on net operating assets (RNOA) and the high leverage. Both net profit margin and net operating asset turnover are on the low end. However, this large discrepancy does not exist when gross margins are compared. O'Charley's gross margin is higher than that of Brinker International and only slightly lower than the industry average of 21%. Thus, O'Charley's low net margins are not due to a low pricing strategy which would create a higher asset turnover; they are due to high costs. The low net profit margin in comparison to the nearly average gross profit margin indicates that O'Charley's has some operating issues that are reducing its profitability, confirmed by the low RNOA.

### ***Leverage***

O'Charley's Current Ratio, Quick Ratio, and Total D/E Ratio are all average compared to its competitors. Like other similar restaurants, O'Charley's does not have high liquidity. Financial Leverage of 0.632 is higher than competitors, but since this ratio is averaged over two years and is higher than the D/E ratio from the current period, it appears that O'Charley's reduced debt from 2003 to 2004 while increasing common equity. However, O'Charley's has a much lower ability than competitors to cover its interest expense.

### ***Valuation***

O'Charley's has a higher than average P/E ratio and the lowest P/B ratio. Although investors see this company growing in the future, the growth is not considered to be very profitable.

### ***Historical Trends***

See Tables 5 and 6 for O'Charley's historical financial ratios. A look at the last three years does highlight the change from 2002 to 2003 in many ratios, likely caused by the purchase of the Ninety Nine restaurant chain. The Dupont Analysis over the last three years shows a decrease in return on equity over the last three years. The decrease in net margins is a primary cause of the declining ROE, as leverage and asset turnover increased in 2003. O'Charley's appears to be struggling since the acquisition of Ninety Nine Restaurants.

**Table 5**

		2002	2003	2004
Basic Dupont Model	Net Profit Margin	0.041	0.028	0.027
	x Total Asset Turnover	1.231	1.447	1.364
	x Total Leverage	1.871	1.968	2.016
	= Return on Equity	0.095	0.080	0.074
Advanced Dupont Model	Net Operating Margin	0.049	0.041	0.038
	x Net Operating Asset Turnover	1.453	1.735	1.684
	= Return on Net Operating Assets	0.071	0.071	0.064
	Net Borrowing Cost (NBC)	0.029	0.056	0.048
	Spread (RNOA - NBC)	0.042	0.014	0.016
	Financial Leverage (LEV)	0.585	0.641	0.632
	ROE = RNOA + LEV*Spread	0.095	0.080	0.074

All margins have decreased since 2002, indicating multiple factors in O'Charley's lower profitability such as increasing food and labor costs in addition to the challenges of operating a new set of restaurants. On the bright side, O'Charley's has become more efficient at managing its working capital. Receivables are collected more quickly, and payables are paid more quickly.

Although debt apparently spiked in 2003, the leverage ratios declined again in 2004. The company has also decreased its ability to cover interest expense since 2002.

**Table 6**

		2002	2003	2004
Margin Analysis	Gross Margin	23.0%	19.0%	18.6%
	Net Profit Margin	4.1%	2.8%	2.7%
Turnover Analysis	Net Working Capital Turnover	(48.301)	(43.776)	(44.019)
	Avg Days to Collect Receivables	5.156	4.537	4.168
	Avg Days to Pay Payables	11.677	8.560	7.753
Analysis of Leverage	Debt to Equity Ratio	0.574	0.692	0.578
	Current Ratio	0.656	0.613	0.675
	Quick Ratio	0.258	0.256	0.205
	EBIT Interest Coverage	8.369	3.298	3.434

Going forward, it is not clear whether the company has the ability increase its profitability despite great efforts to grow the business.

## Forecasting

### Income Statement Assumptions:

**Sales Growth: 2004 = 14.8%, 2005 Forecast = 14.1%, Terminal Forecast = 5%**

- See Table 7a for past performance. Based on restaurant averages, we were able to estimate the contribution of each restaurant chain to the company's overall revenues.
- To calculate each restaurant chain's sales growth, we took into account regional data. Therefore we projected growth of 4.8% for O'Charley's and Stoney River, whose locations are concentrated in the Midwest and South. We only forecasted 2% growth for Ninety Nine because of its locations primarily in the Northeast.
- We estimated sales growth at each restaurant by using the formula:  $[(1 + \text{store growth}) \times (1 + \text{same store growth})] - 1$ .
- Then, based on the data in Table 7a, we estimated each restaurant's contribution to overall sales growth. This information is summarized in Table 7b.

**Table 7a- Explanation of Sales Contribution by Restaurant**

2003 - 2004			
Chain	Avg Weekly Rev 2004	Avg # of Restaurants 2004	Gross Rev 2004
O'Charley's	\$52,703	213.5	\$585,108,706
Ninety Nine	\$52,777	93	\$255,229,572
Stoney River	\$75,267	6	\$23,483,304
Total			\$863,821,582

**Table 7b- Explanation of Sales Growth Forecasts**

2005 Estimated					
Chain	Expected Openings	Store growth	Same store sales growth*	Total Forecasted Growth	Forecasted Sales
O'Charley's	15	7.0%	4.80%	12.16%	\$656,275,464
Ninety Nine	13	13.98%	2.00%	16.26%	\$296,724,960
Stoney River	2	33.33%	4.8%	39.73%	\$32,814,003
Total					\$985,814,428
					<b>Overall Forecasted Growth</b>
					14.1%

\*Based on regional industry growth

**COGS/Sales: 2004 = 81.4%, 2005 Forecast = 82%, Terminal Forecast = 82.5%**

- An increase in food costs would increase this percentage, because we didn't feel that the company would be able to pass on all of the cost increases.
- Automation and expansion could decrease this percentage because costs could be better spread out.
- The industry trend seems to be that COGS will increase.<sup>7</sup>

**SG&A/Sales: 2004 = 8.8%, 2005 Forecast = 8.5%, Terminal Forecast = 9%**

- Rising salary costs due to shrinking labor force

<sup>7</sup> [http://www.businessweek.com/investor/content/oct2004/pi2004105\\_8789\\_pi041.htm](http://www.businessweek.com/investor/content/oct2004/pi2004105_8789_pi041.htm)

- In long run, SG&A costs will be higher due to higher market competition which may require higher marketing and promotion costs.

***Dep&Amort/Avg PP&E and Intang: 2004 =7.1%, 2005 Forecast = 7.1%, Terminal Forecast = 7.1%***

- The company trend is toward leasing stores rather than buying them, so we expect little change in PP&E, and constant depreciation for the short term.

***Interest Exp/Avg. Debt: 2004 = 6.7%, 2005 Forecast =7%, Terminal Forecast = 7%***

- According to the information on page 30 of the 10-K report, we saw that the weighted average interest rate rose from 6.2% in 2003 to 6.9% in 2004. Based on this trend plus the assumption that interest rates would rise, we forecast this ratio to be 7.0%.

***Effective Tax Rate: 2004 = 28.6%, 2005 Forecast = 30%, Terminal Forecast = 35%***

- We think that the company's income tax credits will go down, but they won't hit the corporate rate of 35% until the terminal year.
- We left other future years below 35% because they will have some federal general business tax credits (until 2024) and they will be able to use some of their deferred tax assets in the short term.<sup>8</sup>

### **Balance Sheet Assumptions:**

***Ending Operating Cash/Sales: 2004 = 1.2%, 2005 Forecast = 1.2%, Terminal Forecast =1.0%***

- Has been declining the last few years
- Similar to comparable firms in the industry

***Ending Inventories/COGS: 2004 = 4.7%, 2005 Forecast = 4.6%, Terminal Forecast =4.6%***

- Average of last four years
- Inventories as a percentage of COGS should not change in the industry.

***Ending Taxes Payable/Sales: 2004 = 1.1%, 2005 Forecast = 0%, Terminal Forecast =0%***

- Only had a value in most recent year; previous years were all 0%

***Ending Other Current Liabs Sales: 2004 = 6.8%, 2005 Forecast = 6.5%, Terminal Forecast =6.5%***

- Has been declining as sales increased in last few years

***Ending Net PP&E/Sales: 2004 = 51.8%, 2005 Forecast = 49%, Terminal Forecast =45%***

- Initial value of 49% was chosen to attain a Capital Expenditure value between 70 and 80 million, as specified in the annual report.
- This ratio has been declining as sales increased in last few years.
- A big drop occurred in 2003 when Ninety Nine Restaurants were purchased and all the stores were leased.
- O'Charley's has done some sale/lease back transactions recently and may continue to do more in the future to bring this ratio in line with competitor ratios.

***Ending Intangibles/Sales: 2004 = 13.7%, 2005 Forecast = 13.3%, Terminal Forecast =10%***

- Intangibles are made up of Goodwill, which does not change as sales increase and may even decrease when checked for impairment.
- Goodwill may increase if O'Charley's grows through acquisition in the future, thus this ratio was not brought down all the way to 0%.

***Long-Term Debt/Total Assets: 2004 = 13.7%, 2005 Forecast = 13.3%, Terminal Forecast =10%***

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<sup>8</sup> P 58 of the 2004 10-K report

- Smooth down to 25% to be in line with comparable firms

For all other income or balance sheet items not discussed above, we did not make any forecasting changes due to the lack of evidence for change.

### *Sensitivity Analysis*

The sensitivity analysis below demonstrates that O'Charley's stock price is very sensitive to changes in the terminal values analyzed. By changing the terminal year (2015) sales growth by 1% greater than the base case 5% (which has been the historical restaurant industry sales growth from 1970-2004) there is a dramatic increase in the stock price from \$33.34 to \$131.51. On the other hand, the stock price does not drop as dramatically as the percentage of sales growth is decreased. The sensitivity analysis demonstrates that O'Charley's stock price is most sensitive to changes in the terminal year percentage of cost of goods sold which is logical since cost of goods sold impacts the gross margin. Additionally, the stock price was also fairly sensitive to changing assumptions in the ending net PPE/sales ratio. Given O'Charley's recent activity with sale-leaseback transactions and the acquisition of Ninety Nine restaurants, who lease all of their restaurants, the ending net PPE/sales ratio has been declining. If the sale-leaseback trend in this industry continues, it is very plausible that O'Charley's net PPE/sales ratio will continue to decrease. Finally, the stock price is more sensitive to changes in the cost of equity than it is to changes in the capital structure debt ratio.

	Negative Scenarios			Base Case	Positive Scenarios		
<b>%Sales Growth (FY2015)</b>	1.00%	2.00%	4.00%	5.00%	6.00%	7.00%	8.00%
<b>Price/Share (\$)</b>	\$18.19	\$19.28	\$24.40	\$33.34	\$131.51	(\$15.73)	\$0.64
<b>%COGS(FY2015)</b>	90.00%	87.50%	85.00%	82.50%	80.00%	78.00%	75.00%
<b>Price/Share (\$)</b>	(\$238.89)	(\$148.15)	(\$57.41)	\$33.34	\$124.08	\$196.67	\$305.56
<b>%SG&amp;A (FY2015)</b>	12.00%	11.00%	10.00%	9.00%	8.00%	7.00%	6.00%
<b>Price/Share (\$)</b>	(\$75.33)	(\$39.11)	(\$2.89)	\$33.34	\$69.56	\$105.78	\$142.00
<b>END NET PPE/SALES (FY2015)</b>	55.00%	50.00%	48.00%	45.00%	43.00%	41.00%	38.00%
<b>Price/Share (\$)</b>	(\$22.04)	\$5.65	\$16.72	\$33.34	\$44.41	\$55.48	\$72.10
<b>LT Debt/Assets (FY2015)</b>	40.00%	35.00%	30.00%	25.00%	20.00%	15.00%	10.00%
<b>Price/Share (\$)</b>	\$41.03	\$38.47	\$35.90	\$33.34	\$30.77	\$28.20	\$25.64
<b>Cost of Capital</b>	10.00%	8.50%	7.00%	6.20%	6.00%	5.50%	4.50%
<b>Price/Share (\$)</b>	\$3.10	\$7.08	\$17.28	\$33.34	\$41.39	\$89.79	(\$104.22)

## Valuation

### *Cost of Equity*

Using the CAPM formula<sup>9</sup>, we estimated the cost of equity capital for O'Charley's to be 6.2%. While this number appears to be low, it is in line with the 6.39% cost of equity reported on Yahoo! Finance.

### *Valuation Models*

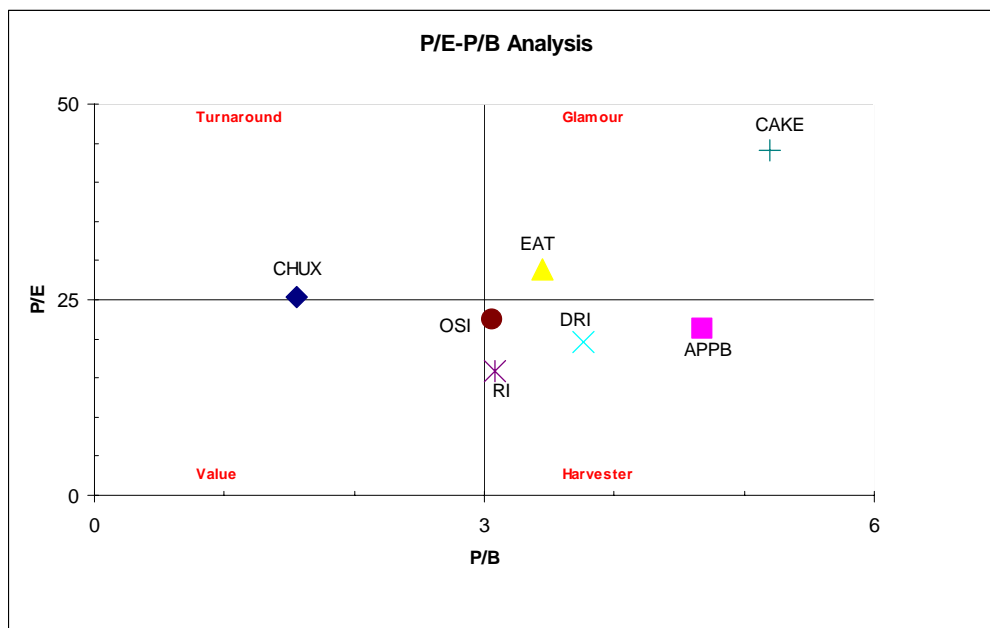
To value O'Charley's, two approaches were used, Residual Income (RI) and Discounted Cash Flow (DCF). The present value of 10 years of residual incomes plus terminal value discounted at the cost of equity, 6.2%, is \$752.5M. After subtracting \$40M in contingent equity claims, the final residual income valuation is \$712.4M (Appendix XX). On a per share basis, the residual income model values the firm at \$33.34. The positive residual income figure indicates the company's ROE will exceed its cost of capital, and that value is being generated for stakeholders. The DCF model arrives at a largely different figure

<sup>9</sup> Rf = 4.45% (10yr T-bond rate as reported on Yahoo! Finance), Rm-Rf = 7.6%, B=.23 (as reported on Yahoo! Finance)

due to its treatment of debt. O'Charley's has \$178M of long term debt. The DCF model incorporates this figure, minus cash into the valuation of the firm. Additionally, the DCF model utilizes the weighted average cost of capital instead of the cost of equity. The WACC for O'Charley's is 7.18%, versus the cost of equity at 6.2% (Appendix YY). This difference is attributed to the cost and quantity of debt. The DCF model arrives at a lower discounted value for cash flows, \$413M (versus \$752.5M for the residual income model). This difference is largely explained by the difference in discount values used within the model. The DCF model discounted the cash flows at WACC, 7.18%, rather than the cost of equity, 6.2%. The \$413M is further reduced by subtracting the net long term debt amount of \$168M. On a per share basis, the DCF model values O'Charley's at \$11.48. The large difference in share price between the DCF model and the Residual Income model is attributed to the discount rate utilized, and the subtraction of net debt from the DCF model. Both models utilized a 5% terminal growth rate which is in line for the historically always growing restaurant industry.

### Valuation Ratios

When comparing the current valuation ratios for O'Charley's with their competitors in the restaurant industry, O'Charley's is borderline between a value stock and a turnaround stock. Therefore, the market expects O'Charley's to have mild growth and profitability. The market views O'Charley's as having lower growth and profitability than The Cheesecake Factory (CAKE) or Brinker's International (EAT), but higher growth expectations than Applebee's (APPB) or Outback Steakhouse (OSI).



### Conclusion and Recommendation

The valuation of O'Charley's demonstrates a strong sensitivity to operational costs and the cost of goods. Although the company is expected to grow in the near future by opening new stores, the challenges of increasing same store growth and reaching market saturation may require O'Charley's to acquire more chains in order to sustain growth profitably. Acquiring new chains has certain costs associated with learning to run a new operation, which caused a dip in profitability in 2003. However, we believe O'Charley's is on the verge of a turnaround based on their growth strategy, assuming they can keep their costs under control. Our valuation gives us a price of \$33.34 per share, versus a price of \$22.05 as of April 5, 2005. Based on our findings, we find O'Charley's stock to be undervalued and recommend a buy.

## Appendix A – Residual Income Valuation Model

Re = 6.2%  
Growth = 5%

Fiscal Year of Forecast	12/31/2005	12/31/2006	12/31/2007	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	
<b>Valuation to Common Equity</b>									
Net Income	26,625	30,314	33,369	36,428	39,434	42,327	45,045	47,880	
Common Equity at Beginning of Year	330,740	369,421	413,678	459,422	505,986	552,602	598,412	644,817	
Residual Income	6,120	7,410	7,721	7,944	8,063	8,065	7,943	7,721	
Present Value of Residual Income	5,762	6,570	6,446	6,245	5,968	5,622	5,213	4,822	
Present Value Beyond 20 Years	297,632								
Present Value of First 20 Years	89,782								
Common Equity as of									
12/31/2004	330,740								
Forecast Equity Value Before Time Adj.	718,153								
Forecasted Value as of Valuation Date	752,530								
Less Value of Contingent Equity Claims	(40,155)								
Value Attributable to Common Equity	712,375								
Common Shares Outstanding at BS Date	21,370								
Equivalent Shares at Valuation Date	21,370								
Forecast Price/Share								<b>\$33.34</b>	

## Appendix B – Discounted Cash Flow Valuation Model

Year	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
FCF		(12,056)	(13,943)	(12,374)	(10,136)	(7,182)	(3,484)	961	6,126	11,958
g =	5%									
Re =	7.18%							FCF (T+1)		18,369

Discount Rate	Perpetual Growth Rate	Total PV of		NPV Terminal Value	Terminal Value 2013	Net Debt	NPV Plus Debt	Shares Outstanding	Price Per Share
		Future Cash Flows	Cash Flows 2005 to 2013						
6.00%	2.00%	\$233,354	-\$38,464	\$271,818	\$459,231	\$167,747	\$65,607	21370	\$3.07
6.00%	2.50%	\$272,185	-\$38,464	\$310,649	\$524,835	\$167,747	\$104,438	21370	\$4.89
6.00%	3.00%	\$323,960	-\$38,464	\$362,424	\$612,307	\$167,747	\$156,213	21370	\$7.31
6.00%	3.50%	\$396,445	-\$38,464	\$434,909	\$734,769	\$167,747	\$228,698	21370	\$10.70
6.00%	4.00%	\$505,172	-\$38,464	\$543,636	\$918,461	\$167,747	\$337,425	21370	\$15.79
6.00%	4.50%	\$686,384	-\$38,464	\$724,848	\$1,224,615	\$167,747	\$518,637	21370	\$24.27
6.00%	5.00%	\$1,048,808	-\$38,464	\$1,087,271	\$1,836,922	\$167,747	\$881,061	21370	\$41.23
6.25%	2.00%	\$212,098	-\$38,364	\$250,462	\$432,217	\$167,747	\$44,351	21370	\$2.08
6.25%	2.50%	\$245,493	-\$38,364	\$283,857	\$489,846	\$167,747	\$77,746	21370	\$3.64
6.25%	3.00%	\$289,163	-\$38,364	\$327,527	\$565,207	\$167,747	\$121,416	21370	\$5.68
6.25%	3.50%	\$348,714	-\$38,364	\$387,077	\$667,972	\$167,747	\$180,967	21370	\$8.47
6.25%	4.00%	\$434,731	-\$38,364	\$473,094	\$816,410	\$167,747	\$266,984	21370	\$12.49
6.25%	4.50%	\$569,901	-\$38,364	\$608,264	\$1,049,670	\$167,747	\$402,154	21370	\$18.82
6.25%	5.00%	\$813,206	-\$38,364	\$851,570	\$1,469,538	\$167,747	\$645,459	21370	\$30.20
6.50%	2.00%	\$193,335	-\$38,262	\$231,596	\$408,205	\$167,747	\$25,588	21370	\$1.20
6.50%	2.50%	\$222,284	-\$38,262	\$260,546	\$459,231	\$167,747	\$54,537	21370	\$2.55
6.50%	3.00%	\$259,505	-\$38,262	\$297,767	\$524,835	\$167,747	\$91,758	21370	\$4.29
6.50%	3.50%	\$309,133	-\$38,262	\$347,395	\$612,307	\$167,747	\$141,386	21370	\$6.62
6.50%	4.00%	\$378,612	-\$38,262	\$416,874	\$734,769	\$167,747	\$210,865	21370	\$9.87
6.50%	4.50%	\$482,830	-\$38,262	\$521,092	\$918,461	\$167,747	\$315,083	21370	\$14.74
6.50%	5.00%	\$656,527	-\$38,262	\$694,789	\$1,224,615	\$167,747	\$488,780	21370	\$22.87
6.75%	2.00%	\$176,667	-\$38,158	\$214,826	\$386,720	\$167,747	\$8,920	21370	\$0.42
6.75%	2.50%	\$201,941	-\$38,158	\$240,099	\$432,217	\$167,747	\$34,194	21370	\$1.60
6.75%	3.00%	\$233,954	-\$38,158	\$272,113	\$489,846	\$167,747	\$66,207	21370	\$3.10
6.75%	3.50%	\$275,818	-\$38,158	\$313,976	\$565,207	\$167,747	\$108,071	21370	\$5.06
6.75%	4.00%	\$332,904	-\$38,158	\$371,063	\$667,972	\$167,747	\$165,157	21370	\$7.73
6.75%	4.50%	\$415,362	-\$38,158	\$453,521	\$816,410	\$167,747	\$247,615	21370	\$11.59
6.75%	5.00%	\$544,940	-\$38,158	\$583,098	\$1,049,670	\$167,747	\$377,193	21370	\$17.65
7.18%	2.00%	\$151,945	-\$37,977	\$189,922	\$354,526	\$167,747	-\$15,802	21370	-\$0.74
7.18%	2.50%	\$172,230	-\$37,977	\$210,207	\$392,391	\$167,747	\$4,483	21370	\$0.21
7.18%	3.00%	\$197,366	-\$37,977	\$235,343	\$439,313	\$167,747	\$29,619	21370	\$1.39
7.18%	3.50%	\$229,330	-\$37,977	\$267,307	\$498,980	\$167,747	\$61,583	21370	\$2.88
7.18%	4.00%	\$271,342	-\$37,977	\$309,319	\$577,403	\$167,747	\$103,595	21370	\$4.85
7.18%	4.50%	\$329,021	-\$37,977	\$366,998	\$685,073	\$167,747	\$161,274	21370	\$7.55
7.18%	5.00%	\$413,143	-\$37,977	\$451,120	\$842,103	\$167,747	\$245,396	21370	\$11.48

Cost of Equity Capital:  $Re = Rf + B(\text{Market Premium}) = 6.20\%$       Cost of Debt      9%

Rf      4.40%

B      0.23

Rm-Rf      7.60%

Total Shareholders Equity:      \$330,740      Long Term Debt:      178,469      Wacc:      7.18%

Cash      10,722

Net Debt      167,747

## Appendix C: Financial Statements

Fiscal Year End (MM/DD/YYYY)	Actual 12/31/2004	Forecast 12/31/2005	Forecast 12/31/2006	Forecast 12/31/2007	Forecast 12/31/2008	Forecast 12/31/2009	Forecast 12/31/2010	Forecast 12/31/2011	Forecast 12/31/2012	Forecast 12/31/2013	Forecast 12/31/2014	Forecast 12/31/2015
<b>Income Statement</b>												
Sales (Net)	871,386	994,251	1,125,393	1,263,591	1,407,262	1,554,461	1,702,912	1,850,044	1,993,053	2,128,979	2,254,801	2,367,541
Cost of Goods Sold	(709,018)	(815,286)	(923,948)	(1,038,672)	(1,158,176)	(1,280,876)	(1,404,903)	(1,528,136)	(1,648,254)	(1,762,794)	(1,869,230)	(1,965,059)
Gross Profit	162,368	178,965	201,445	224,919	249,085	273,585	298,010	321,908	344,798	366,184	385,571	402,482
R&D Expense		0	0	0	0	0	0	0	0	0	0	0
SG&A Expense	(76,293)	(84,511)	(95,658)	(107,405)	(119,617)	(132,129)	(144,748)	(157,254)	(169,409)	(180,963)	(191,658)	(201,241)
EBITDA	86,075	94,454	105,787	117,514	129,468	141,456	153,262	164,654	175,389	185,221	193,913	201,241
Depreciation & Amortization	(39,798)	(42,334)	(46,684)	(51,995)	(57,436)	(62,921)	(68,356)	(73,635)	(78,649)	(83,287)	(87,436)	(90,993)
EBIT	46,277	52,120	59,103	65,519	72,032	78,535	84,907	91,019	96,739	101,935	106,477	110,248
Interest Expense	(13,476)	(13,947)	(15,331)	(16,984)	(18,661)	(20,333)	(21,969)	(23,538)	(25,004)	(26,335)	(27,496)	(28,459)
Non-Operating Income (Loss)	(120)	(137)	(155)	(174)	(194)	(214)	(235)	(255)	(274)	(293)	(311)	(326)
EBT	32,681	38,036	43,616	48,361	53,178	57,988	62,703	67,226	71,460	75,307	78,670	81,463
Income Taxes	(9,362)	(11,411)	(13,303)	(14,992)	(16,751)	(18,556)	(20,378)	(22,185)	(23,939)	(25,604)	(27,141)	(28,512)
Minority Interest in Earnings		0	0	0	0	0	0	0	0	0	0	0
Other Income (Loss)		0	0	0	0	0	0	0	0	0	0	0
Net Income Before Ext. Items	23,319	26,625	30,313	33,369	36,427	39,432	42,324	45,042	47,521	49,702	51,529	52,951
Ext. Items & Disc. Ops.		0	0	0	0	0	0	0	0	0	0	0
Preferred Dividends		0	0	0	0	0	0	0	0	0	0	0
Net Income (available to commo)	23,319	26,625	30,313	33,369	36,427	39,432	42,324	45,042	47,521	49,702	51,529	52,951
<b>Balance Sheet</b>												
Operating Cash and Market. Sec	10,772	12,077	13,429	14,806	16,188	17,547	18,857	20,089	21,214	22,204	23,032	23,675
Receivables	8,783	10,021	11,343	12,736	14,184	15,668	17,164	18,647	20,089	21,459	22,727	23,863
Inventories	33,125	37,503	42,502	47,779	53,276	58,920	64,626	70,294	75,820	81,089	85,985	90,393
Other Current Assets	11,718	13,370	15,134	16,992	18,924	20,904	22,900	24,879	26,802	28,630	30,322	31,838
Total Current Assets	64,398	72,972	82,407	92,314	102,572	113,039	123,547	133,909	143,924	153,381	162,065	169,769
PP&E (Net)	451,808	487,183	546,941	609,051	672,671	736,815	800,369	862,121	920,790	975,072	1,023,680	1,065,394
Investments	0	0	0	0	0	0	0	0	0	0	0	0
Intangibles	118,995	132,469	146,201	159,955	173,465	186,443	198,589	209,599	219,177	227,049	232,974	236,754
Other Assets	22,310	25,456	28,813	32,352	36,030	39,799	43,599	47,366	51,028	54,508	57,729	60,616
Total Assets	657,511	718,080	804,363	893,672	984,739	1,076,096	1,166,105	1,252,995	1,334,919	1,410,010	1,476,448	1,532,533
Current Debt	12,670	13,837	15,500	17,221	18,976	20,736	22,470	24,145	25,723	27,170	28,451	29,531
Accounts Payable	14,259	16,306	18,489	20,796	23,202	25,674	28,176	30,664	33,093	35,412	37,571	39,519
Income Taxes Payable	9,184	0	0	0	0	0	0	0	0	0	0	0
Other Current Liabilities	59,271	64,626	73,151	82,133	91,472	101,040	110,689	120,253	129,548	138,384	146,562	153,890
Total Current Liabilities	95,384	94,769	107,140	120,151	133,650	147,450	161,336	175,062	188,365	200,966	212,584	222,941
Long-Term Debt	178,469	193,510	215,195	237,347	259,615	281,603	302,886	323,014	341,532	357,997	371,989	383,133
Other Liabilities	45,034	51,384	58,161	65,304	72,729	80,336	88,008	95,612	103,003	110,028	116,530	122,357
Deferred Taxes	7,884	8,996	10,182	11,433	12,732	14,064	15,407	16,739	18,032	19,262	20,401	21,421
Minority Interest		0	0	0	0	0	0	0	0	0	0	0
Total Liabilities	326,771	348,659	390,678	434,234	478,725	523,454	567,637	610,426	650,932	688,253	721,503	749,851
Preferred Stock		0	0	0	0	0	0	0	0	0	0	0
Paid in Common Capital (Net)	174,372	186,428	200,378	212,762	222,911	230,107	233,609	232,668	226,565	214,633	196,292	171,077
Retained Earnings	156,368	182,993	213,307	246,676	283,103	322,535	364,859	409,901	457,422	507,124	558,653	611,604
Total Common Equity	330,740	369,421	413,685	459,438	506,014	552,642	598,468	642,569	683,987	721,757	754,945	782,682
Total Liabilities and Equity	657,511	718,080	804,363	893,672	984,739	1,076,096	1,166,105	1,252,995	1,334,919	1,410,010	1,476,448	1,532,533
<b>Statement of Retained Earnings</b>												
Beg. Retained Earnings	135,997	156,368	182,993	213,307	246,676	283,103	322,535	364,859	409,901	457,422	507,124	558,653
+Net Income	23,319	26,625	30,313	33,369	36,427	39,432	42,324	45,042	47,521	49,702	51,529	52,951
-Common Dividends		0	0	0	0	0	0	0	0	0	0	0
+/-Clean Surplus Plug (Ignore)	(2,948)	0	0	0	0	0	0	0	0	0	0	0
=End. Retained Earnings	156,368	182,993	213,307	246,676	283,103	322,535	364,859	409,901	457,422	507,124	558,653	611,604

## Appendix D: Forecast Assumptions

Company Name												TERMINAL
Forecast Horizon												YEAR
Estimated Price/Share=\$33.30												
Fiscal Year End Date	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast
	12/31/2005	12/31/2006	12/31/2007	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012	12/31/2013	12/31/2014	12/31/2015	
Implied Return on Equity	0.076	0.077	0.076	0.075	0.074	0.074	0.073	0.072	0.071	0.070	0.069	
<b>Income Statement Assumptions</b>												
Sales Growth	14.1%	13.2%	12.3%	11.4%	10.5%	9.6%	8.6%	7.7%	6.8%	5.9%	5.0%	
Cost of Goods Sold/Sales	82.0%	82.1%	82.2%	82.3%	82.4%	82.5%	82.6%	82.7%	82.8%	82.9%	83.0%	
R&D/Sales	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
SG&A/Sales	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	
Dep&Amort/Avg PP&E and Intang.	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%	
Interest Expense/Avg Debt	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	
Non-Operating Income/Sales	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Effective Tax Rate	30.0%	30.5%	31.0%	31.5%	32.0%	32.5%	33.0%	33.5%	34.0%	34.5%	35.0%	
Minority Interest/After Tax Income	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Other Income/Sales	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Ext. Items & Disc. Ops./Sales	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Pref. Dividends/Avg Pref. Stock	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
<b>Balance Sheet Assumptions:</b>												
<b>Working Capital Assumptions</b>												
Ending Operating Cash/Sales	1.2%	1.2%	1.2%	1.2%	1.1%	1.1%	1.1%	1.1%	1.0%	1.0%	1.0%	
Ending Receivables/Sales	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	
Ending Inventories/COGS	4.6%	4.6%	4.6%	4.6%	4.6%	4.6%	4.6%	4.6%	4.6%	4.6%	4.6%	
Ending Other Current Assets/Sales	1.3%	1.3%	1.3%	1.3%	1.3%	1.3%	1.3%	1.3%	1.3%	1.3%	1.3%	
Ending Accounts Payable/COGS	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	
Ending Taxes Payable/Sales	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Ending Other Current Liabs/Sales	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	
<b>Other Operating Asset Assumptions</b>												
Ending Net PP&E/Sales	49.0%	48.6%	48.2%	47.8%	47.4%	47.0%	46.6%	46.2%	45.8%	45.4%	45.0%	
Ending Investments/Sales	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Ending Intangibles/Sales	13.3%	13.0%	12.7%	12.3%	12.0%	11.7%	11.3%	11.0%	10.7%	10.3%	10.0%	
Ending Other Assets/Sales	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	2.6%	
<b>Other Operating Liability Assumptions</b>												
Other Liabilities/Sales	5.2%	5.2%	5.2%	5.2%	5.2%	5.2%	5.2%	5.2%	5.2%	5.2%	5.2%	
Deferred Taxes/Sales	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	0.9%	
<b>Financing Assumptions</b>												
Current Debt/Total Assets	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%	
Long-Term Debt/Total Assets	26.9%	26.8%	26.6%	26.4%	26.2%	26.0%	25.8%	25.6%	25.4%	25.2%	25.0%	
Minority Interest/Total Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Preferred Stock/Total Assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Dividend Payout Ratio	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	