

## MII INVESTMENT MEMO

**TO:** MCINTIRE INVESTMENT INSTITUTE  
**FROM:** JON HAAS (SECOND YEAR)  
**SUBJECT:** CPKI - LONG  
**DATE:** NOVEMBER 29, 2009

### CALIFORNIA PIZZA KITCHEN, INC. (NSDQ: CPKI) RECOMMENDATION – BUY NOVEMBER 29, 2009



1-year performance charted against S&P 500 and 200-day MA

Price (11/27/09): \$12.65  
Market Cap: \$305.91M  
52-Week Range: \$6.99-17.44  
P/E: 15.81  
Price/Sales: 0.47  
ROE: 4.8%  
Quick Ratio: 0.35  
Debt-to-Equity: 0.70  
Short Ratio: 8.9  
Total Cash: 14.35M  
Total Debt: 37M  
Beta: 1.48

#### Company Overview

“California Pizza Kitchen, Inc. engages in the ownership, operation, license, and franchising of a chain of casual dining restaurants in the United States. The company provides pizzas, pastas, salads, and appetizers. It offers various categories of pizzas, including traditional, American style, tomato sauce-based, and Italian style Neapolitan pizza. The company operates restaurants under the California Pizza Kitchen, California Pizza Kitchen ASAP, and LA Food Show Grill and Bar names. It has a trademark license agreement with Kraft Pizza Company to manufacture and distribute a line of California Pizza Kitchen frozen pizzas in the United States and Canada. As of March 12, 2009, the company operated, licensed, or franchised 253 locations in 32 states of which 205 were company owned and 48 operated under franchise or license agreements. It also has operations in the United Arab Emirates, Guam, Hong Kong, China, Indonesia, Japan, Malaysia, Mexico, the Philippines, Singapore, and South Korea. The company was founded in 1985 and is headquartered in Los Angeles, California.” (Yahoo! Finance)

CPK operates in the premium pizza segment, drawing most of its revenue from sit-down restaurants located predominately in California and along the eastern seaboard. The firm operates in an incredibly competitive industry, establishing itself as a provider of gourmet, imaginative pizzas and other dishes in order to differentiate itself from other national brands and local pizzerias.

The company’s financial statements assert that, “Our objective is to extend our leadership position in the restaurant and premium pizza market by selling innovative, high quality pizzas and related products and by providing exceptional customer service, thereby building a high degree of customer loyalty, brand awareness and superior returns for our stockholders. To reach these objectives, we plan to increase our market share by expanding our restaurant base in new and existing markets, leveraging our partnerships in non-traditional and retail channels and offering innovative menu items on our platform of pizzas.”

#### Thesis Points

*-Competitive frozen pizza line hedges CPK against economic fluctuations, fills premium frozen pizza void, and improves forecasting.*

CPK currently maintains a trademark license agreement with Kraft Pizza Co., a subsidiary of Kraft Foods Inc., for the manufacturing and distribution of a line of CPK-branded frozen pizzas to be sold in supermarkets and food stores across the US and Canada. This agreement enables CPK to enter the frozen pizza market without directly investing in the massive infrastructure, currently possessed by Kraft, needed to produce, market, and distribute the product. Aside from taking advantage of these economies of scale, the firm has established a competitive advantage in the sector. VAR demonstrates the superior taste and quality of CPK pizzas in comparison to frozen pizza competitors, and CPK has broken the generic frozen choices of cheese, pepperoni, or supreme by offering a variety of gourmet pies, such as Pesto Chicken, Five Cheese and Spinach, Original BBQ Chicken, and Hawaiian Pizzas, in both family and For One sizes. Though the

10-15% price premium on CPK products does turn away value-conscious consumers (read: college kids), quality, frequent sales pricing, and the CPK brand have helped to attract many consumers to the frozen brand. Thus, this frozen line has served as a macroeconomic hedge for CPK, as recessionary environments force consumers to lessen their trips to CPK restaurants and increase frozen pizza consumption, which CPK can now capitalize on (as evidenced by a 35.1% increase in frozen pizza revenue in Q3 2009). Frozen pizza serves as a staple food in the US even for more well-off consumers; CPK, as the only premium frozen pizza brand in the industry, is in a position to continue to draw business from more affluent consumers who will still consume frozen pizza but will be willing to pay for gourmet dishes. The frozen line also benefits the restaurant chain and vice versa. Sales of frozen pizzas in different locations provide management with data that will help in determining restaurant expansion locations, and satisfied frozen pizza consumers will look to go to the restaurant while restaurant-goers will try the frozen pizza brand. CPK is currently the only pizza maker to operate in both the frozen and restaurant industries.

*-Gourmet pizza and other premium menu items provide a competitive advantage in the restaurant and pizza industry:*

Like their frozen pizza line, CPK succeeds in a competitive industry by providing pizza beyond the traditional toppings and flavors of chains and local pizzerias. While “normal” toppings like Cheese, Pepperoni, Meat Lover’s, and Margherita are available (and quite good), CPK truly distinguishes itself through its more “interesting” dishes. Examples of these include:

**Came Asada:** Grilled steak, fire-roasted mild chilies, onions, cilantro pesto, Monterey Jack, and Mozzarella cheeses. Served with a side of tomatillo salsa and fresh tomato salsa.

**Pear and Gorgonzola:** Caramelized pears, Gorgonzola, Fontina and Mozzarella cheeses, caramelized sweet onions and chopped hazelnuts. Topped with field greens tossed in our Gorgonzola ranch dressing.

**Chipotle Chicken:** This one is HOT & SPICY! Grilled chipotle chicken, fire-roasted mild chilies, chipotle sauce, Mozzarella and Enchilado cheeses. Topped with roasted corn & black bean salsa, cilantro and lime cream sauce. Also available with grilled steak instead of chicken.

Appetizers, salads, pastas, and other menu items express similar creativity, providing diners with unique and innovative options while offering high-quality classics for more picky eaters. As I show through VAR and as I can assure through personal experience and the experiences of my friends, diners absolutely love the quality and taste featured on CPK’s menu and often return to try new items, pizza or otherwise, or order old favorites. Again, CPK finds itself in a unique niche in the pizza industry as the premium brand, with individual pizzas usually costing \$10-\$12 and average checks per person around \$14. Though expensive in comparison to other pizza competitors like Pizza Hut, Papa John’s, and local restaurants, CPK prices often fall shy of those at similar quality restaurants, like Cheesecake Factory and Outback Steakhouse. While some responses in my poll for VAR expressed reservations about the price (partially explained by the predominance of college students, known to be value-conscious), many asserted that the restaurant offered great quality and value for its price.

CPK does not remain idle even with its unique menu, frequently innovating, inventing, and reinventing dishes to match consumer tastes and demand. Financial statements note that, “Our menu is continuously evolving to track the increasingly discriminating and sophisticated palate of the American public. We regularly review the sales mix of our menu items and replace lower selling items in each category with new menu items once or twice a year.” Recent additions to the menu include new takes on the Original BBQ Chicken pizza, two new soups, three new sandwiches, steak and fish tacos, two cheesecakes, and the option to use multigrain pasta in any dish (an option already in place for pizza crust with honey wheat dough).

CPK’s unique, gourmet, and innovative menu will enable it to draw in new customers and retain previous diners as the chain expands. The chain is the sole place for diners looking for premium pizza, and while some are concerned about prices, this has not stopped these same people from eating at the restaurant anyway. Future rises in disposable income from a recovering economy will also lead to improved sales and profits in the long run.

*-Successful promotions, expansion strategy serve to attract new customers and secure business of returning diners:*

CPK’s efforts to draw a larger consumer base will ultimately produce greater profits for shareholders and solidify the firm’s place as one of the premiere pizza brands in the US and the world. The firm is currently expanding beyond its current 255 locations, with a focus on adding additional locations to existing markets. While concern about cannibalization of sales seems to be a valid reaction, this is not the case. Louis Vtsas, manager of the Wayne, NJ restaurant, explained that many locations, his included, often had difficulties in serving all potential diners during busy hours (my local restaurant, for example, can oftentimes develop 45 minute waits on weekends during the lunch and dinner rushes). Thus, additional locations will not cannibalize sales, but will spread out crowds in order to serve more diners and will improve efficiency and profitability. In addition, expansion in existing markets takes advantage of economies of scale by spreading fixed costs in distribution, advertising, control, etc... while avoiding the risk involved in expanding to new markets. While many locations are

currently in malls and shopping centers, CPK's most recent 10-K stresses a focus on adding restaurants on or near toll roads, airports, and other oft-travelled locations.

CPK also attracts diners through various successful promotion efforts. The most important of these is the "Menu Adventure Guarantee", prominently displayed on the menu and on the website, pushing customers to try new dishes with the promise to replace the item if the diner doesn't like it. This, of course, tempts customers to try some of the more "interesting" dishes, hopefully finding a favorite item most likely not featured at any other restaurant, without worrying about diners refusing to come back after not enjoying a specific dish. In late 2008 and early 2009, the chain gave cards containing anything from 10% off to one million dollars to diners, who could only redeem the card (and learn what theirs contained) by having the manager open it on their next visit. While this is only anecdotal evidence, I remember returning with my girlfriend *twice* to use these cards before the deadline, and on both occasions we saw multiple parties presenting cards to be opened, meaning that the promotion actually drew customers to come back to the restaurant. Currently, CPK is offering a free \$20 CPK gift card to customers who buy \$100 or more in gift cards for the holidays. These promotional efforts have worked alongside the restaurant's quality menu to draw new and returning customers and demonstrate management's skill in attracting diners.

### **Misperceptions – Where is our Edge?**

I believe that despite the well-founded and expanding market position of CPK due to its menu and strategy, investors and analysts have focused on bad news in the short term, dragging down the price. Despite beating analyst EPS projections in Q3 2009, share prices changed little, most likely due to the decrease in same-store sales and total revenue (yoy). Furthermore, CPK expects same-store sales to again drop in the 4<sup>th</sup> Quarter and has set its EPS guidance at \$0.16-0.18, below the Street's projection of \$0.20. I believe this bad news has caused the stock to lose almost 25% of its value over the last two months.

However, VAR has demonstrated the superiority of CPK's product and revealed the firm to be an incredibly popular establishment that must expand to meet constantly increasing demand for its product. Further expansion should drive sales in new stores and, in conjunction with the success of the frozen pizza line, revitalize and improve same-store sales. In addition, macroeconomic factors must be considered. CPK is a premium brand that has many locations in shopping centers, high-end malls, and airports. The effects of any economic recovery will be felt by consumers of the goods and services provided at these locations later than other industries, meaning that any significant pickup in CPK traffic due to increased consumer disposable income will be delayed (in a relative sense). Thus, I believe that the Street's focus on the short term (as represented by several analyst projections and a short ratio of 8.9) provides us with a window to take a position before the true value of the firm is recognized and the stock price is adjusted accordingly.

### **Risks**

- Macroeconomy: prolonged economic recession would leave consumers with little disposable income and little job security, forcing consumers to forego eating out at CPK restaurants and downgrading to less expensive, lower quality frozen pizzas. While this is somewhat hedged by the frozen pizza line, as discussed above, revenues and net income will nevertheless be adversely affected
- Wheat/Ingredient Prices: pizza and many other items produced by CPK are based on wheat products, meaning fluctuations in the price of wheat and other "raw materials" in preparing food will affect costs and profit margins
- Air travel: the success of CPK ASAP locations and the proposed future expansion of full-service restaurants in airport locations are subject to the volume of air travel, as less people flying means less consumers dining at airport locations and vice versa
- Cannibalization: Expansion in existing markets, despite VAR evidence to the contrary, could result in cannibalization of sales between new and existing locations.

### **Projections and Recommendation**

I believe that California Pizza Kitchen will be a valuable addition to MIP's long portfolio. On the portfolio-management side of things, CPKI fits in well, as we currently have no exposure to the more high-end consumer sector (assuming we consider Coach as high-end luxury). I am not concerned about unnecessary risk from holding both CPKI and YUM (which owns Pizza Hut), as the two brands fill completely different niches in the same industry. Pizza Hut focuses on value and features delivery, while CPK emphasizes quality and a sitdown experience with an enjoyable atmosphere, ambience, etc... Furthermore, an investment in CPK would focus on quality, innovation, and recovery and expansion within the US, while our position in YUM is based mostly off expansion prospects in China and now India. Thus, if anything, the two positions would hedge each other to a degree.

While I do not see CPKI as a "grand slam," triple digits return investment, I do see a potential for solid growth over the next several years as CPK successfully builds its brand, expands its influence, and attracts new and returning customers, with the Street eventually recognizing its long term value and driving up its price. I therefore recommend that CPKI be added to the portfolio at 5%.

# VAR Addendum

## 1. CPK Survey

This survey, done through SurveyMonkey, was designed to learn about the popularity of CPK restaurants and frozen pizza, determine dining and spending habits, and obtain any miscellaneous thoughts or opinions about CPK. An invitation to complete the survey was sent to all of my Facebook friends (about 950 individuals), of which 61 completed the survey, approximately a 6.5% response rate. I should note that using my Facebook friends as a sample will yield somewhat biased results, as most participants were between 13 and 25 years old and most likely do not represent the proper socioeconomic strata of CPK diners. Nevertheless, this data does provide some interesting information:

-When asked to rate several pizza brands (CPK, Papa John's, Dominos, Pizza Hut, DiGiorno, Red Baron, Tombstone) by quality, 67% of respondents identified CPK as having the highest quality, followed by Papa John's and Dominos with 8.9% each.

-Only 5 of the 61 respondents had never been to a CPK restaurant. Of those who have been to CPK, 73% indicated that they had been multiple (more than two) times.

-When asked to rate different aspects of their dining experience at CPK as "Poor", "Below Average", "Average", "Above Average", or "Excellent", 85% of respondents described the food as "Above Average" or "Excellent" and 78% did the same for "Overall Experience". 21% described the cost as "Below Average", but this can be explained by the heavy bias towards cost-conscious college students in the sample.

-I asked participants to tell me about their drink ordering preferences (alcoholic and non-alcoholic) when eating out in general, as drink sales at restaurants have very high margins and often drive profits. Of 61 respondents, 7 always order a drink, 17 usually order a drink, 25 usually order water, and 12 always order water. I will discuss drinks further down on this page, but this shows that consumers are willing to spend money to buy non-water drinks, which is incredibly beneficial to the restaurant industry and indicates increased disposable income.

-When asked for their favorite brand of frozen pizza, I received a number of different brands, but a good number of people said that DiGiorno, Ellios, Tombstone, or Pizza Bagel Bites were their favorite. Only three people listed CPK as their favorite.

-64% of respondents have never tried CPK frozen pizzas, although 64% of those who have tried them have done so more than once or eat them frequently. Again, the low number of respondents trying the pizzas is affected by sampling bias.

-On a scale for overall satisfaction from 1 to 10, with 10 being the highest, the average for those who have tried CPK frozen pizzas was 7.7. Only one respondent ranked them below a 5.

### Selected miscellaneous comments:

"Prices are a bit high, especially in this economy, where there are many cheaper options available"

"Have more locations"

"Lower their prices"

"I love CPK"

"Nothing tops CPK!"

"Great quality and price, have only done carryout but every time it was ready fast. need to open up in more cities, there's not one in my hometown or anywhere nearby. "

"The frozen pizzas do not give CPK pizza justice"

"I wish I could eat some right now"

"Amazing pizza, salads, and soup!"

"California Pizza Kitchen is absolutely delicious"

(Note: raw data can be provided upon request)

## 2. Frozen Pizza Taste Test

In order to determine if CPK possessed any competitive advantage in quality and taste over other frozen brands, I purchased several different types of frozen pizzas in order to hold an unofficial "taste test". I tried several of the pizzas myself, and I had Andrew Sufka (SEAS IV) join me in eating and reviewing three different brands of thin crust pepperoni pizza. Having never previously tried any of the

frozen pizzas I ate, I considered myself to be a fair test subject. In addition, I have no incentive to skew information to support CPK, as my goal is the performance of the fund, not addition of CPK to the portfolio.

Individual Pizzas:

- CPK Flatbread Melt – Chicken and Bacon Club
  - Price: \$3.99
  - Calories: 390
  - Opinion: looked good when prepared, but nothing special in terms of taste.
    - Definitely wouldn't pass at a restaurant
    - Too small for meal, good only as snack
- CPK "For One" Cheese Pizza
  - Price: \$3.99
  - Calories: 510
  - Opinion: Box looks much better than pizza itself
    - Very oily
    - Good sauce, bread – tastes authentic
    - You can tell it is a frozen pizza, but considering that its pretty good
- DiGiorno "For One" Cheese Pizza
  - Price: \$3.49
  - Calories: 720
  - Opinion: Cheese is good, but way too much bread
    - 720 calories is a lot for a pizza that size
    - Sauce has strange aftertaste
    - Similar to pizza at sporting events
    - Definitely not delivery
- CPK "For One" Pesto Chicken Pizza
  - Price: \$3.99
  - Calories: 430
  - Opinion: looks and smells really good once prepared
    - Everything good, but crust not really crispy
    - Not very oily, which is good when using pesto
    - Very unique
    - Red peppers were good



While the flatbread melt was mediocre at best, the Pesto Chicken pizza was unique and very good, and the CPK cheese pizza was noticeably better than the DiGiorno one, even taking into consideration the \$0.50 price difference.

Thin Crust Pepperoni Pizzas (Opinions given by Andrew Sufka):

- Red Baron
  - Like: cheese, bread
    - "you can tell it's frozen pizza"
  - Dislike: sauce
    - "it's kinda there, but it doesn't taste like much"
- DiGiorno
  - Like: pepperoni, parmesan cheese sprinkles
    - "Good pepperoni coverage"
  - Dislike: bread, oil
    - "tasteless"
    - "you can tell it's not freshly made"
- CPK
  - Like: sauce, seasoning, cheese
    - "unique taste"



- “tomato sauce tastes real”
- Dislike: pepperoni
  - “not as much pepperoni [as other brands], but I do like the cut of the pepperoni and the taste as well”
  - “a lot of people don’t like CPK because they garnish [the pizza] up too much”

When asked to rank various aspects of the pizzas, Andrew decided on the following:

Taste Test Pizza Rankings			
	CPK	DiGiorno	Red Baron
Crust	2	3	1
Sauce	1	2	3
Cheese	tie	tie	tie
Pepperoni	1	2	3
Overall	1	3	2
With same price, buy:			CPK
Prices as they are, buy:			Red Baron

Andrew noted that while CPK was the best in terms of quality, he chose Red Baron as a compromise between quality and price.

Andrew’s additional comments on CPK pizza:

- Wishes the frozen pizza was larger, it would “help sell up the extra dollar”
- “lines up *pretty well* with restaurant”
  - “because the restaurant is so good it helps sell [the frozen pizzas]”
- “If people perceive the frozen pizzas to be overpriced, they will perceive the restaurant to be overpriced”

3. Don Danich – Asst. Manager, Harris Teeter, Charlottesville, VA

- Frozen pizzas always sell well, no matter the economic environment
- CPK sells well *when it’s on sale*
- However, it is one of the slower-selling brands when not on sale
  - Note: this means that other pizzas are on sale at this time  
sign of value-conscious consumers in weaker economy
- Sale rotation determined by corporate
- “frozen foods guy” was not at the store when I visited
  - Follow-up VAR source

4. Dined at CPK restaurant, Wayne, NJ

- Spoke to Louis Vtsas, Manager
  - Northeast locations performing very well
    - \$16 avg check/person, \$14 is national average
    - Exceeding sales goals
    - Conversely, CA locations having some trouble
  - New menu items selling very well
    - Tacos, cheesecakes especially
  - CPK is “nothing like TGI Friday’s, Applebees, Ruby Tuesday... everything is fresh, not frozen...we provide quality service”
  - Excited about expansion plan
    - “My location will be less busy and we won’t have to turn away as many customers as we do now”
  - Personally likes frozen pizza line – “the Garlic Chicken Pizza is better than what I can make in the kitchen here”
- Order (split with one other person)
  - Thai Crunch Salad, \$9.50
  - Traditional Cheese Pizza, honey wheat dough, \$10
  - Jamaican Jerk Chicken Pizza, honey wheat dough, \$12.50
  - Everything was really good, very unique dishes



- The salad came out literally two minutes after ordering it
- Observations
  - Restaurant was about 70% full on a Wednesday at 1:00
    - Got more crowded as we ate, almost full when we left
  - Diners were a mix of families, friends, couples, small and large groups
  - Overheard two women talking at table next to us, discussing what to order – “the soup is good, the salad is good, everything is good”
  - Very quick, courteous service, even though the restaurant was crowded
- Drinks
  - I attempted to look around my table and count the number of drinks people had ordered and the number of waters people had ordered
  - From my (very unofficial) count, I saw 23 people with drinks and 8 people with water
  - Again, this is very good for CPK, economy
    - Drinks are one of the first things that people with less disposable income downgrade from
    - Restaurants make huge profit margins on drinks
      - Costs of a drink, which can sell for \$1.50-\$2.00, are negligible
      - Very large part of restaurant profits
  - The fact that people were ordering drinks on a Wednesday afternoon lunch shows that people are willing to spend money to upgrade their dining experience – this mindset can really drive CPK’s business

#### 5. Michael Osanloo, VP of Strategy, Kraft Foods Inc.

- Awaiting response to email query
- Looking to hear Kraft’s rationale for partnering with CPK
  - What benefit do they derive?
  - Why CPK?
  - Are they worried about competition and cannibalization with their brand, DiGiorno?

### **Ideas For MII**

-Consider setting aside part of a meeting once or twice at the beginning of each semester for people to openly and quickly introduce investment ideas in an open forum style, with each person taking 30 seconds to identify the company in question and briefly highlight basic reasons for the idea. I hate to refer to this as a “Lightning Round” due to my dislike of a certain mad TV investing personality, but that’s essentially what it is. This will help get investment ideas out in the open, as I guarantee there are MII members who have come upon quality companies but don’t have the time or haven’t taken the initiative to write a memo or simply don’t know what to do next (i.e. underclassmen). Managers can then talk with members of the club and get the person with the idea or someone else to go write a memo and/or pitch the stock later in the semester.

-Start up an “Intro to Analyst” program, where managers work with groups of newer members (underclassmen) who may be very interested in investing but unsure of where to start. Depending on what newer members need, an unofficial program like this would help to educate members about investing basics and, most importantly, the process of researching and preparing for a memo/pitch. Topics like using a stock screener, finding good investment ideas, VAR, fundamental analysis, and other such topics (maybe even advanced things like basic valuation and modeling) would be of great help to newer members who are usually not in the Comm School and have not been previously exposed to this. This will make newer members more comfortable with what goes on at MII, more willing to write memos and pitch to get their ideas out to the fund, and will help to cut down on presentations that don’t always meet MII standards in terms of VAR, finding under/overvalued stocks, etc...

-Institute a program to more or less assign a watchlist idea to a prospective analyst for him/her to research and create a memo or give a pitch. As a first year last year I was really interested in MII but did not really know how to go about finding a suitable investment idea to pitch. While this may be an example of the “give a man a fish/teach him to fish” concept, it could help newer members get off on the right foot by enabling them to focus on research and analysis without worrying about finding a knock-your-socks-off investment idea first and provides a clear channel through which investment ideas on the watchlist (and, perhaps, those generated in a “Lightning Round”