CASE FIVE

Boston Chicken, Inc.[1]

At the end of 1996, Boston Chicken was one of the hottest names on Wall Street. Operating in the highly competitive restaurant industry, the chain had grown from 18 stores in 1991 to over 1,000 stores in 1996 and in its short history had raised over $1 billion in public offerings. EPS had grown from just $0.06 in 1993 to $1.01 in 1996, representing an annual growth rate of well over 100 percent. At the end of 1996, Boston Chicken traded around $40, representing a price-earnings multiple of 40 and a market-book ratio of 3. The company's spectacular success was attributed to the leadership of a group of investors headed by Scott Beck, former vice chairman of Blockbuster Entertainment, who took control in 1992. Enthusiasm for the company in 1994 was summarized in *The Washington Post* as follows:

> Perhaps no company better captures the spirit of the new economy than Boston Chicken Inc., the hottest of last year's hot stock offerings, which aims to do for the rotisserie what Col. Sanders did for the deep fryer . . . But Boston Chicken is not really about poultry—it is about developing a market-winning formula for picking real estate, designing stores, organizing a franchise operation and analyzing data.[2]

However, enthusiasm for the company was not universal. Doug Kass, research chief of brokerage J. W. Charles of Boca Raton, Florida, commented:

> I wouldn't touch Boston Chicken with a 10-foot rotisserie spit. I'm concerned with some major accounting issues, excessive stock valuation, surging competition and heavy dependence on a single product.[3]

Boston Chicken's management staunchly defended the company against such criticism. CFO Mark Stephens responded:

> We've got great chicken, great side items, our accounting is fine, and we're growing like a weed. When you get a big profile, it's natural for people to shoot at you.

Boston Chicken also took two steps to reduce its reliance on rotisserie chicken in 1995. First, Boston Chicken extended its food offerings to include turkey, ham, and meatloaf, and concurrently changed the name of its stores to Boston Market. Second, Boston Chicken diversified its food offerings further by investing in ENBC, which was created through the combination of a number of leading bagel retailers.

Against this backdrop, Boston Chicken entered 1997 with plans to open over 300 additional restaurants over the next 12 months. The continued expansion was to be financed through the issuance of over $400 million of convertible debt in the first half of 1997. Enthusiasm for Boston Chicken remained high on Wall Street, with many Wall Street analysts recommending the stock as a "strong buy."

Details concerning Boston Chicken's business strategy and financial performance and expansion plans are provided in the company's Form 10-K for the year ended December 29, 1996. This document is available as an online exhibit at www.lundholmandsloan.com.

QUESTIONS

1. Evaluate the structure of the restaurant industry and its ability to generate profits over the long run. As a starting point, consider the five forces of competition:
   • Competition from substitutes.
   • Rivalry between established competitors.

---

[1] This case was prepared by Professor Richard Sloan as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation.
[2] From Steven Pearlstein, "Boston Chicken: Hot Stuff," *The Washington Post,* July 4, 1994.
[3] Dan Dorfman, "Pros Roast Chicken Stock," *USA Today,* August 12, 1994

- Threat of entry.
- Bargaining power of customers.
- Bargaining power of suppliers.

2. Some analysts argue that Boston Chicken (BOST) is primarily in the business of operating restaurants. Other analysts argue that BOST is primarily a franchiser, as opposed to an operator of restaurants. Still others argue that BOST is primarily a financial institution that lends money to operators of restaurants. Based on the information provided in the case, what do you view as BOST's primary business and why?
3. Evaluate BOST's strategy for creating competitive advantage. What are the key success factors and risks associated with this strategy?
4. Evaluate the quality of BOST's earnings.
5. Restate BOST's earnings using a method that better reflects the underlying economics of the business. (Financials are available in Excel format at www.lundholmandsloan.com.)
6. Assuming that BOST continues to use its current accounting methods, what future event(s) are likely to cause its quality of earnings problems to surface
(i.e., what future event(s) will cause BOST's future earnings to be lower because current earnings are potentially overstated)?