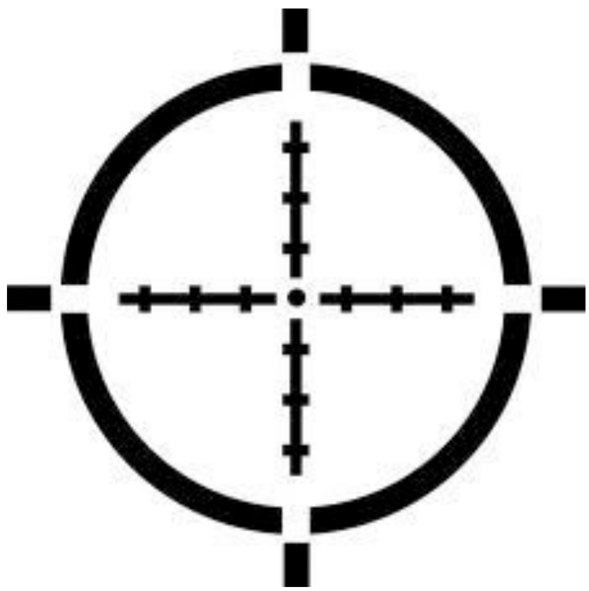
POTBELLY SANDWICH WORKS

Client Report

DangerZone Consulting



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Executive Summary

DangerZone sees Potbelly Sandwich Works as a promising fast casual sandwich restaurant that rightly boasts of a great brand focused on healthy food options for hip and trendy consumers. With close to 300 stores it is at a critical stage of shaping its long-term strategy and has all the ingredients to become and industry leader provided that Potbelly strategically positions itself to operate at the cusp of the exciting and fast growing fast casual industry.

Potbelly is very focused on preserving its brand and this has been evident in its very calculated growth trajectory in the early 2000's. Currently, it possesses a strong management team, menu and business model that has the potential of taking Potbelly to the next level domestically and internationally. However, its most recent quarter has shed doubts on Potbelly's potential and many think they are treading on thin ice.

Very slow expansion, a decrease in number of entrees ordered from 2012 to 2013 and a harsh winter have made Potbelly's situation a little bit bitter for the markets to swallow. These shortcomings have the potential to lead to even bigger problems for the company in the near future.

DangerZone's focus for Potbelly is to establish a very concrete and well thought out growth strategy that does not simply focus on growing the number of stores but focuses on harnessing existing geographical experiences and strengths in Midwest and Northeast to strategically identify and enter new markets. With this in mind, we propose a possible expansion to the fast casual market in Florida. We believe this move presents a strong market for Potbelly as well as geographical diversification away from winter prone areas.

In the absence of a well-defined international strategy, we advise Potbelly to slow down international expansion and increase attention and resources to solidifying Middle Eastern operations. A strong foothold in the Middle East would position Potbelly to take advantage of its fast casual market and establish a stronghold for further expansion. A potential market to look at in the next 3 to 5 years would be Latin America.

Additionally, DangerZone recommends strengthening Potbelly's franchising programming to serve Potbelly's overall franchise driven growth strategy. Cutting high development costs and providing stronger financial support by partnering with a reliable franchise financer would protect franchise investments in the long run. In terms of franchising structure, we recommend that Potbelly add multi unit franchise options to its offering to take advantage of successful single unit franchisors and cut down on franchise search costs.

To address Potbelly's decreasing entree sales, DangerZone is pleased to present to our client, Potbelly Gold, a unique rewards program that stays true to the values of Potbelly and leverages the company's technology and social media platforms for enhanced customer engagement. Our recommendation comes based on the economics of rewards programs: behavioral studies have shown significantly large and positive effects of incentive programs for general purchases. With Potbelly's commitment to community engagement, we take the rewards program model a step further and propose a program feature that would give customers the chance to earn and donate rewards to local charities. This completes a growth strategy that we believe stays true to the Potbelly's commitment to quality service and company goal of "making people really happy."

Company History

Founded in 1977 by Peter Hastings, Potbelly Sandwich Works is one of the nation's fastest growing food service companies with a recently established international presence in the United Arab Emirates. It occupies a market space known as fast casual- a blend between the traditional fast food model and the full table service restaurant model. Potbelly is known for its commitment to creating a warm, quirky and friendly ambience while providing fresh and fast sandwich options. The stores, unique with their own distinct personality, are inspired by the neighborhoods they are built in. Throughout the years, Potbelly has gradually expanded to over 297 stores[1]. While a few shops are franchises, the vast majority is company owned with a strong and continued commitment to establishing itself as a premier fast casual restaurant option for customers.

The original store is located in Chicago, in a retail space that was previously an antique store called Hindsight, owned by the Hastings [2]. In an attempt to attract more customers to their shop, they decided to start serving lunch. Their sandwiches quickly developed a cult following and eventually became their main business model complete with toasty sandwiches, homemade desserts and the occasional live music. In 1996, Bryant Keil, an entrepreneur, purchased the original store and embarked on an expansion campaign with a strong dedication to preserving the uniqueness of each shop in an attempt to keep the brand from solely becoming a fast food chain.

Potbelly went national in the early part of the 21ST century, after a huge capital investment of $11 million by private equity firms William Blair & Company, Waveland Investments, Oxford Capital Partners, Inc. as well as the lesser-known venture capital firm, Maveron LLC under the leadership of Howard Schultz and Dan Levitan, the men behind Starbucks Corporation. For their investment, principals from each venture firm gained a seat on Potbelly's board of directors[3].

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[1] Potbelly.com About Us Section
[2] Potbelly.com History Section
[3] "Potbelly Sandwich Works Inc. International Directory of Company Histories. 2007. Encyclopedia.com. 3 February 2014.

By the end of 2001, there were eight Potbelly's in the Chicago land area, with plans to take the sandwich chain outside Illinois. Three leases had been secured in the Washington, D.C. area and plans progressed for several Midwestern states as well. Revenues for Potbelly were steadily growing, reaching a reported $15 million for the year.

Potbelly continued its expansion campaign in 2002 with 11 locations in and around Chicago, each one bringing in as much as $1.3 million. By the following year, there were 30 Potbelly restaurants in Illinois, Washington, D.C. as well as Michigan[4]. Sales were reportedly $40 million for the year, due in part to strategic executive hiring and strong marketing campaigns.

By 2006, Potbelly had grown to more than 110 outlets and had estimated sales of $150 million. While Potbelly could not compete with the size of Subway, which controlled a third of the nationwide sandwich market, the small chain continued to grow by carving its own niche in the food service industry. To keep its competitive edge and fund further expansion, a new round of private financing was secured in the summer of 2006. This was amidst rumors of a pending IPO offering.

On November 5th 2007, a new Potbelly store in Glen Ellyn, Illinois, became the first to feature a drive-through. A second drive-through store was added shortly thereafter. In 2008, online ordering was launched nationwide. In 2011, Potbelly opened two franchise stores in Dubai in the United Arab Emirates; these are the first international Potbelly locations and were a step towards establishing Potbelly as an international brand. In August 2013, Potbelly took the next step in its expansion campaign and filed an IPO with US regulators to raise up to $75 million. Shares in the company began trading on the NASDAQ Stock Market on October 4, 2013[5]

Potbelly's menu has evolved over the years and currently features a variety of sandwiches that are all served hot on regular or multigrain wheat bread. All sandwiches can be ordered "thin-cut"

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[4] Potbelly.com History Section
[5] Yahoo Finance

style, in which one third of the bread is cut out. Potbelly began offering salads in February 2007. The menu also includes soup, shakes, malts, smoothies, and cookies. Some locations offer Starbucks coffee along with a breakfast menu[6]. Most restaurants feature live music from local musicians during the lunch hours.

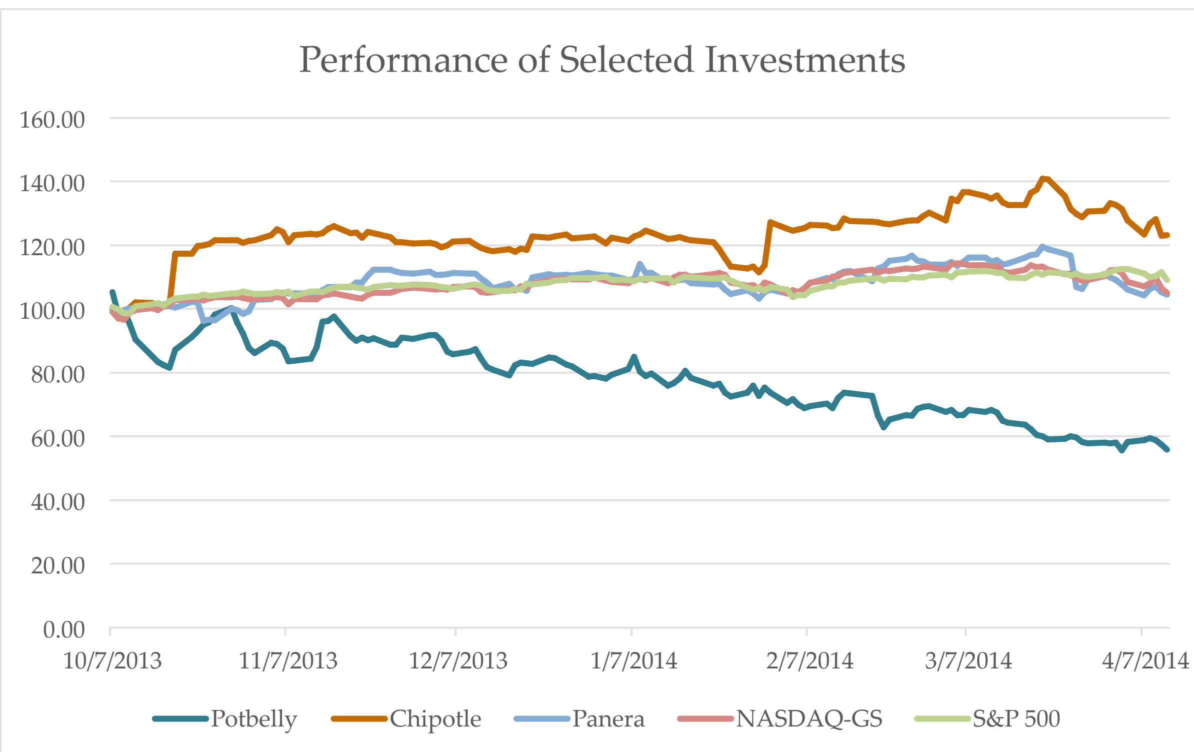
Potbelly goes to great lengths to make their shops special by procuring and creating little touches, quirks and local artifacts that reflect the neighborhood of each shop. This is a direct result of their commitment to not falling into the purely fast food category. In addition, Potbelly incorporates live lunch performances by local musicians that support a non-profit in the area in which the store is located. This localized corporate social responsibility is in stark contrast to traditional corporate responsibility models especially within the restaurant industry.

[6] Potbelly.com Menu Section

Financial Analysis

From Potbelly Corporation's initial public offering of common stock on October 7, 2013 to the close of trading April 11, 2014, the value of its common stock has declined 44%. This runs in sharp contrast to the shares of its main publicly traded competitors, Chipotle Mexican Grill and Panera Bread, which have posted positive gains of 23.2% and 5.6%, respectively. Potbelly has been outperformed by the index on which it trades, the NASDAQ-GS, as well as the broader market-tracking S&P 500 index, which have posted returns of 5.1% and 9.2% percent, respectively. A summary of the performance of a $100 investment made on October 7, 2013 in all of these companies or exchanges is included in the graph below.

Figure 1:



Clearly, Potbelly has failed to meet investors' expectations since its IPO six months ago. It has lagged behind both its competitors and the broader market as a whole. DangerZone believes that the company's failure to meet analysts' expectations for earnings has been the main reason for its tumbling stock price since its October IPO.

Recent quarter and annual reports show that Potbelly posted a net loss of $63.7 million for FY 2013, down from net profit of $13.5 million in FY 2012[7]. However, it should be noted that these numbers are affected by a number of one-time expenses and events. Immediately following its IPO, Potbelly paid out a one-time $49.9 million cash dividend to its original investors and repaid $14 million of an outstanding credit facility to JP Morgan Chase in addition to investments made to support new shop growth. For fiscal 2013, Potbelly's general and administrative expenses as a percentage of total revenues were 9.7%, excluding the effect of any one-time costs associated with our initial public offering The company has no plans to pay out future dividends and no further loan repayments of such high value are likely to be paid in the near future. Therefore we believe it is more informative to examine Potbelly's net operating income to get a clearer picture of the company's financial performance.

Net operating income decreased to $1.48 million in 2013, down from $8.57 million in 2012. Though total revenues increased, expense growth outpaced revenue growth by three percentage points, contributing to an 82.8% decrease in annual net operating income. Reasons for the decline are manifold, including extreme weather conditions during the winter of 2013-2014 that inhibited revenue growth, increased rent costs resulting from Potbelly's aggressive expansion into high-cost areas such as Boston and New York City, and general administrative expenses which spiked during 2013 because underwriting fees paid to investment banks. As of FYE 2013, Potbelly operated twenty-two stores in New York and Boston, a sharp increase from the five it operated as of FYE 2011. Without consistent revenue growth from sandwich sales in stores, continued expansion into high-rent areas may not be a sustainable strategy.

[7] Potbelly Annual 10K

Because Potbelly earns 99.6% of its revenues from stable company-owned sandwich shop sales and only 0.4% from franchise royalties and fees, it places a high value on year-over-year sales growth in company-owned stores that have been open for fifteen months or longer[8]. This metric, called comparable store sales growth, increased by 1.5% in 2013 over its 2012 level. However, price increases in menu items drove this increase, which offset a decrease in the number of entrees ordered. Dangerzone strongly believes that it will be difficult to maintain revenue growth solely through price increases in the highly competitive fast-casual food business, which defines itself by providing high-quality food at affordable prices. In order to maintain sustainable revenue growth, it will be necessary to increase the count of entrees ordered – demand for Potbelly's sandwiches must increase, not price. Though the exceptionally cold winter of 2013-2014 played a role in declining revenues at Potbelly (especially because the majority of the company's stores are located in cold-weather areas in the United States), Potbelly will need to maintain its price competitiveness with its larger competitors such as Chipotle Mexican Grill and Panera Bread.

To better understand Potbelly's place within the industry, we include an analysis of some key financial metrics for two of Potbelly's competitors. Subway and Jimmy John's are not publicly traded and so they are not included in this analysis.

Table 1

		Chipotle	Panera	Potbelly
Solvency and Leverage Ratios	Debt/EBITDA	0.88	1.53	22.43*
	Interest Coverage Ratio	NA	297.98	3.81
	Debt/Equity	0.31	0.69	0.22

*For FY 2012, this ratio was 5.29, closer to its competitors, but still much higher.

Because Potbelly posted poor earnings, even before one-time expenses such as the $49.9 million dividend payment is figured in, its Debt/EBITDA ratio, a measure of how long it would take for a company's operating income to finance its debt, is far higher than its competitors'. While Chipotle does not have any interest expenses and Panera Bread generates enough income

[8] Potbelly For 10K Annual Report Period ending 12/29/2013

annually to make almost 300 times necessary interest payments, Potbelly can only manage an interest coverage ratio of 3.8 times.

Table 2

		Chipotle	Panera	Potbelly
Profitability Ratios	Gross Margin	36.22%	35.34%	30.82%
	Return on Equity	21.29%	28.03%	45.54%*
	Return on Assets	16.30%	16.61%	41.62%**

* Even if we only use operating income for this metric, it is still 0.96%.

** Likewise, if operating income is used for this metric, it is still low, 0.68%

In addition, Potbelly posted very poor ROE and ROA numbers, lagging behind its larger and more profitable competitors. However, the company's core business of selling sandwiches appears to be financially sound, as Potbelly posts a gross margin of 30.82%, not far behind its competitors, which both stand at slightly over 35%. This suggests that Potbelly will need to cut overhead costs in order to ensure that its final net income numbers are more in line with its gross margin.

Table 3

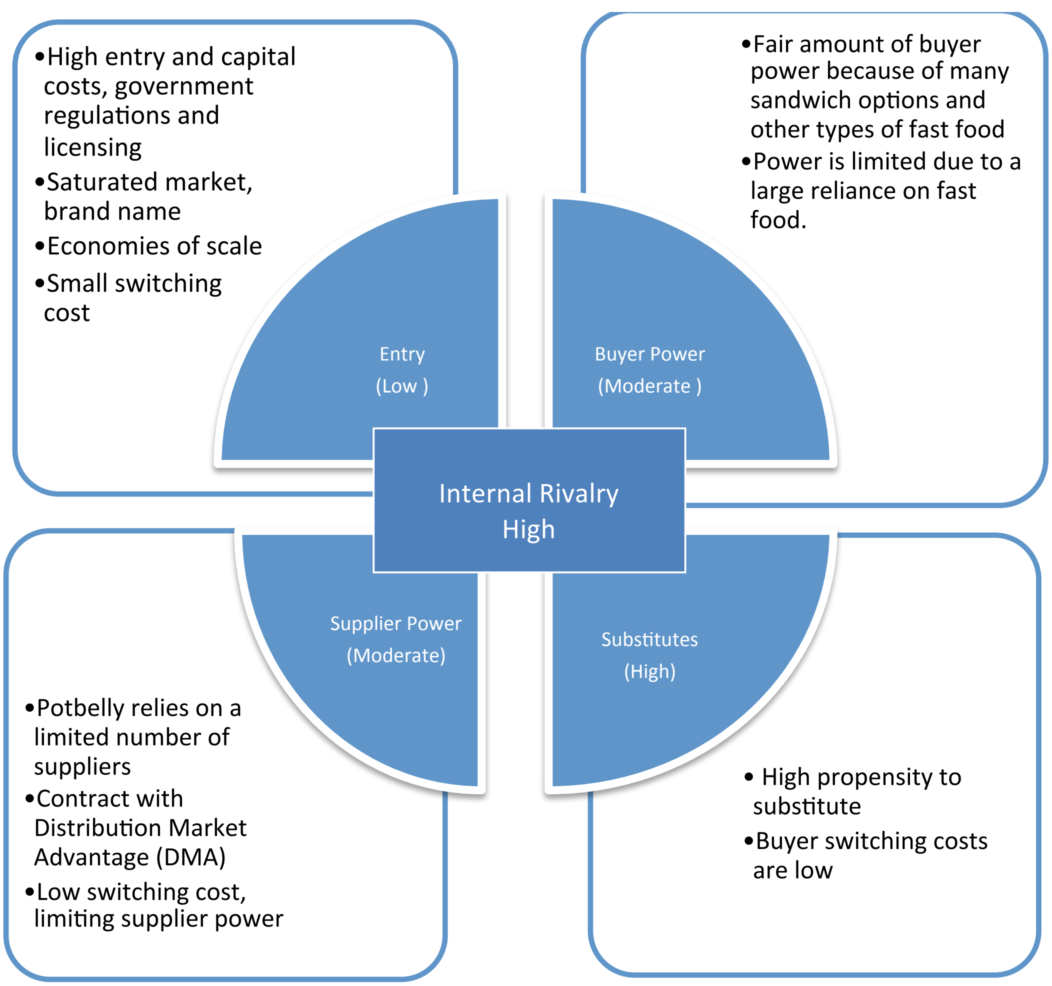
		Chipotle	Panera	Potbelly
Liquidity Ratios	Quick Ratio	3.28	0.93	4.25
	Current Ratio	3.34	1.00	4.37

Fortunately, Potbelly appears to have no major issues with liquidity or leverage, boasting ratios in these areas to its competitors, as it maintains a healthy asset base to protect against sudden shocks. The company maintains a $35 million credit facility with JPMorgan Chase (expiring in 2017), which requires that it maintain a maximum leverage ratio of 2.25:1 and a minimum debt service coverage ratio of 1.5:1. Potbelly currently meets both of these requirements easily, and we believe that the financial gains to be had from maintaining favorable credit terms with the large bank will provide further incentive for Potbelly to keep its finances in order.

FIVE FORCES ANALYSIS

According to new research from The NPD Group, the fast-casual segment's growth in traffic, for the fifth consecutive year, far surpassed that of every other restaurant segment in the 12-month period ended in November 2013. Total customer visits to fast-casual restaurants increased 8 percent for the 12 months ended last November, compared with flat traffic overall for all restaurant segments. The fast-casual segment's average check was $7.40 during that period, higher than the $5.30 average for quick service but well below casual dining's average of $13.66. Unit expansion was the main driver of fast casual's traffic and sales growth last year: for the 12 months ended last November, the number of fast-casual chain locations in the United States rose by 903, or 6 percent, to 16,215 total units and it is projected to increase in the next two years. We describe the industry further using the Porter's Five Force Analysis Model.

Figure 2



Under the Standard Industrial Classification system, fast casual restaurants fall into the category of Eating Places, code 5812. This category is part of the larger industry category of Accommodation and Food Services.

Entry

The threat of new entrants to the fast casual dining industry is low mostly due to the presence of high barriers to entry. The fixed capital cost to initially build a store is high, and significant government regulation surrounds food establishments and franchise licensing, further increasing the barriers. Potbelly has cleared a major hurdle by establishing its current locations and receiving the necessary licenses.

The fast casual dining market is already saturated with many companies with recognizable brand names, making entrance even more difficult. Chains like Panera and Chipotle have reached many areas of the country, and consumers already know what they will get at these restaurants. Smaller, more regional restaurants also crowd the market, making it difficult to establish a new fast casual restaurant.

Significant economies of scale benefit large chains and make it difficult for new entrants to compete on price. Companies like Potbelly and Panera sell large quantities of food across numerous locations, so they can buy supplies in bulk and reduce costs.

Fast casual restaurants tend to have a small switching cost. This cost is primarily determined by restaurant proximity to the consumer, and with so many options packed tightly in most urban areas, switching to a competitor is easy. This makes it easier for entry into the market, as consumers can be convinced to switch from a current choice to a new entrant.

Overall, Potbelly needs to worry more about currently existing competition rather than possible entry of new rivals. Successful chains of fast casual restaurants have well-known names and products and enjoy economies of scale. Low switching cost makes entrance more enticing, but Danger Zone believes that current competition is a much bigger threat.

Buyer Power

Buyers are given a good amount of negotiating power through the saturation of the sandwich and fast casual restaurant markets. With so many dining options, Potbelly customers can easily compare prices and switch to a competitor. This puts pressure on Potbelly to keep prices reasonable and consistently deliver a product that meets customers' expectations.

Buyer power is somewhat reduced by the convenience aspect of the fast-casual restaurant industry. Most of Potbelly's customers are workers who are often on a tight schedule and only have a small amount of time to get lunch. Thus, customers' price elasticity is reduced due to what can be viewed as a convenience premium, as they do not have time or are not willing to compare prices of different restaurants.

Supplier Power

Potbelly depends on consistent product supplies, as it must have the ingredients to make any sandwich on the menu at all times. The low cost of customers switching to competitors makes the unavailability of any menu item a good enough reason to choose another restaurant, which puts some power in the hands of the suppliers.

A small number of suppliers currently provide Potbelly with the food and ingredients the company needs, giving the suppliers a foothold for bargaining in the future. If Potbelly gets all of its bread from one source, this supplier may be able to raise prices without losing the company's business; delivering a consistent product across locations is vital to Potbelly's profitability, and knowing this increases the power of the current suppliers.

Potbelly's contract with Distribution Market Advantage (DMA), a cooperative of food distributors spanning the nation, makes getting supplies easier but also increases supplier power. The union of suppliers allows them to work together to increase their power, but certain parts of Potbelly's contract limits this power. Fixed prices protocols are included in the contract, which prevents price increases during an agreed-upon timeframe. Thus, Potbelly's ties with DMA prevent the exploitation of suppliers but do not simply put all the power in the cooperative's hands.

Overall, supplier power is limited because Potbelly has a low switching cost. The abundance of food distributors gives the company plenty of options, and if a current supplier has costs that are deemed too high, Potbelly has little reason not to switch to another supplier. Potbelly's focus on high quality ingredients limits the number of acceptable suppliers, but supplier power in the industry is still low. There is little to no risk of supplier power resulting in a significant cut in Potbelly's revenues.

Substitutes

Consumers in the fast casual industry have a high propensity to substitute due to factors relating to location, food quality and price. Competitors and substitutes like local delis or "convenient meals" in supermarket delis can take business from Potbelly if they build new convenient locations or offer more enticing quality or prices, so it is vital that Potbelly strategically chooses locations to operate and keeps costs and quality in line with what customers want and expect.

As this report previously mentioned, buyer-switching costs are low, and this serves as the driving force for the high propensity to substitute. Potbelly could help reduce the threat of substitutes by increasing this switching cost through a customer loyalty program.

Complements to Potbelly include beverages and food ingredients, as the costs of these determine the profits the company can reach. These costs tend to be stable over time, so Potbelly does not need to worry too much about changes in its complements.

Internal Rivalry

Potbelly competes with large, national chains, many of which have a much more expansive reach. Subway has the most US locations of any restaurant with 23,336, while Panera has 1,736. In Potbelly's central location of Chicago, over 120 Jimmy John's are in operation. Competition is tough in Chicago with so many Jimmy John's around, so expansion to new locations is important, but Potbelly will be forced to compete with bigger chains like Subway and Panera in most urban US locations.

Potbelly also competes within the larger market for fast food restaurants. While the company's focus on higher quality ingredients differentiates it from many of the other fast food restaurants, many of the fast-food chains, including McDonalds are increasingly focusing on healthier and higher quality food. In addition, many other fast food restaurant chains are looking to improve the quality of their food and restaurant décor. At the same time, there has been a push in the fast-casual market towards keeping prices low and providing better value to consumers. These two forces serve to bring Potbelly and other fast-casual restaurants in more direct competition with the larger fast-food chains. In this larger industry, Potbelly is a much smaller player, with a market cap about one tenth the size of the largest company in the industry, McDonalds Corporation.

Expansion could be tough due to previously established customer loyalty to competitors. Thus, Potbelly must distinguish itself from places like Panera in order to give customers an incentive to try a new product. Switching costs are not an issue, so Potbelly only has to be able to overcome previously established loyalty.

Fast food is responsible for 72.8% of whole food industry's revenues[9]. Thus, Potbelly needs to view fast food as a rivalry source, even if it is not a direct competitor. The market saturation that exists makes it difficult for Potbelly to carve out a niche that will attract customers, so this rivalry needs to be addressed by specific strategies.

[9] http://group5wiki.wikidot.com/competitive

SWOT Analysis

Strengths	Weaknesses
• Experienced management team • Impressive community involvement • Great quality food • Mobile apps • Market Niche • Distinctive ambience	• Highly concentrated geographic operations • Lack of a customer loyalty program • Slowing revenue growth
Threats	**Opportunities**
• Rising food costs • Rising employee expenses • Uncertain economy • Fierce competition	• Attitudinal changes • Expected growth in domestic and international sandwich and fast casual industry.

Strengths

- *Experienced management team and leadership*

  Potbelly's strength lies in its strong management team and board of directors. The wealth of experience and strategic advice is expected to positively shape the long-term future of the organization. Current CEO, Aylwin B. Lewis, was President and Chief Executive Officer of Sears Holdings Corporation, a nationwide retailer, from 2005 to 2008. He also had work experience with Yum! Brands. Potbelly's board of directors and key investors consists of veterans from the retail and restaurant industry that were successful in their respective careers and are in full support of the company's mission and values. Notable among them is Starbucks Corporation Chairman Howard Schultz, whose private equity firm Maveron has made a significant investment in Potbelly.

- *Community involvement*

  Over the years, Potbelly has developed an impressive community engagement program as part of its business model. In line with their philosophy on giving and their overall mission: “To Make People Happy” Potbelly has become an active part incommunities by sponsoring community events and shake fundraisers where 25% of total revenue generated during the event is donated to a cause. This has been vital in separating the Potbelly brand from other fast food sandwich providers and creating a socially responsible brand that appeals to its target audience. It puts Potbelly in a good position to attract additional clients that are more socially conscious about their consumption decisions and by providing spaces for events, leverages the support of local charities to drive foot traffic into their stores. Implicit in this vision of positive impact are the Potbelly Franchisees as well as its employees, making this a company wide commitment.

- *Phone app for ordering and information*

  Potbelly’s iPhone and Android App presents a good foundation for increasing customer engagement via social media and technology by making the potbelly experience convenient and seamless. With these Apps a customer can easily pull up the menu, place and order, enter their credit card for payment, and find the closest restaurant location for pick-up. Additionally, customers can sign up for informational newsletters and provide feedback.

- *Quality of Food*

  Potbelly, as explained earlier, uses “fresh ingredients ” and takes pride in the food they are giving to their customers. Accolades for good quality food includes first place positions in the Sandwich category by Consumer Picks Survey and Trip Advisor Certificate for Excellence award. To qualify for a Certificate of Excellence, businesses must maintain an overall rating of four or higher, out of a possible five, as reviewed by travelers on TripAdvisor, and must have been listed on TripAdvisor for at least 12 months. Additional criteria include the volume of reviews received within the last 12 months. In the Consumer Picks Survey published by Restaurant News, Potbelly beat its competitors and topped the overall sandwich category. Assessment was based primarily on the quality of the food and the overall customer experience. A quick look at customer reviews on Yelp and Google Reviews, two popular reviews sites, shows very favorable ratings for food quality. " Great Sandwiches!" is a comment that runs through many posts.

- *Market Niche*

  Current consumers tastes are now geared towards a blend of convenience and a more inviting in-store experience over speed and convenience. Potbelly has put itself in a great position to capitalize on this market especially in the Chicago area. With its thin and vegan bread slices option Potbelly has established itself as a healthy alternative in the sandwich industry as well.

- *Distinctive Ambiance*

  Potbelly is committed to creating an ambiance in their stores and a culture within Potbelly that is warm, inviting, and embracing. They design each store to provide a distinctive environment, in many cases using fixtures and materials that reflect neighborhood locations as a way to engage customers. Potbelly staff are trained to the highest standards of customer service and have the skills, expertise, and personalities to make each visit a delight. Many of Potbelly stores incorporate the warmth of the iconic potbelly stove and cozy seating areas, which makes it an ideal gathering spot for many customers. Furthermore, Potbelly stores are designed to visually reinforce the distinctive difference between what they have to offer and what their competitors provide.

Weaknesses

- *Highly concentrated geographic operations*

  Potbelly has highly concentrated geographic operations in the Greater Chicago area. This concentration increases the risk of Potbelly's operations and may put them at a disadvantage to their other competitors that have more diversified locations. The United States population is significantly concentrated along its coast, however Potbelly has not taken full advantage of coastal markets and with competitors like Panera Bread pushing the pedal of expansion on the West Coast, Potbelly might be missing out on some key market share.

Furthermore, Potbelly's store footprint is heavily concentrated in a few cities. Chicago's city limits contain more than 40 locations, while Washington, D.C. has more than 20. This means that around 20% of the company's total locations are accounted for in two cities. The last quarter of 2013 saw a government shutdown in Washington and an exceptionally harsh winter in the Midwest. Potbelly ended up taking a very big hit to revenues.

- *Lack of a customer loyalty program*

  Currently, Potbelly lacks a customer loyalty program because of unfounded fears that discounting most often results in higher prices for customers which they claim they want to avoid. The saturated nature of the fast casual market means that food chains like Potbelly need to put its resources into customer retention and loyalty. Potbelly's competitors such as Panera have already established very successful customer loyalty programs that they use to not only engage customers but also collect data that is vital to their long-term strategy.

  Potbelly is unfortunately missing out on these great advantages. Current technology has made the costs of managing a customer loyalty program very affordable and if designed properly can bring in enormous amounts of foot traffic and revenue. McDonalds having realized the advantage is currently piloting its own customer loyalty program.

- *Limited breakfast menu and drive through options*

  The perception that Potbelly is a lunch-only establishment is another issue. A recent study revealed that restaurant breakfast sales were estimated to have reached more than $47 billion in 2013, while they are expected to rise another 5% in 2014. Even though Potbelly serves breakfast, it doesn't have the menu variety or restaurant capability to serve the meal as well as Panera Bread or McDonald's.Likewise, the lack of drive-thru's at the majority of Potbelly locations puts the company at a disadvantage during the morning hours when people are rushing to work. Fast food breakfast options like McDonald's, Dunkin' Brands, and Burger King all have a leg up on Potbelly in this time slot.

Opportunities

- *Changes in Attitude*

  Consumers especially within the United States are becoming increasingly health conscious and aware of obesity and food responsibility. Even if the major fast-food chains have responded by offering more healthy options on their menus, this trend has hurt the Fast Food Restaurants industry, especially hamburger, meat products and fried foods. The Sandwich industry, seen as a healthier alternative, has seen great growth in recent years and is only expected to keep growing. Potbelly has established itself as a player in this market and has the opportunity to capture a significant chunk of this growing market because of its healthy and socially aware image.

- *Expected Growth in Sandwich and Fast Casual Industries*

  Fast-casual sales increased 13 percent in 2012, and the largest chains—those which each made more than $325 million last year—did even better, growing by 16 percent. Fast-casual restaurants continue to outperform both quick-service and full-service establishments and post strong gains even while the rest of the industry is having a more difficult time[10]. Looking forward, the trend is expected to continue. Whereas the compound annual growth rate for all limited-service restaurants is 4.5 percent (2012 through 2017), fast-casual operators are expected to grow 10 percent, on average, over the same period.

Threats

- *Competition*

  Although Potbelly is a very specialized quick-service restaurant, Competition poses a huge threat. Potbelly has both direct competitors that are similar themed chains in the

[10] "Fast Casuals make Inroads" www.npd.com

market and indirect competitors that are other popular fast food and fast casual restaurants. The restaurants that directly compete with Potbelly are Subway, Panera, and Jimmy Johns. Subway is the leader in the Sandwich fast food category, according to a Standard and Poors' report on the Restaurant industry. Potbelly has a number of indirect competitors: McDonalds, Starbucks, Yum! Brands, and Sodexho and may also compete with companies outside the fast casual and quick service and casual dining segments of the restaurant industry. For example, another source of competition could be deli sections, in store cafes. Convenience stores and casual dining outlets that exist to serve the needs of customers looking for higher quality food and present a more diverse menu in better locations and at a significantly lower cost. Among other things these competitors might benefit from, better facilities, better management, more effective marketing and more efficient operations.

- *Economic Uncertainty*

  Revenues in the restaurant industry are highly correlated with the health of the economy. Thus economic uncertainty poses a constant risk. In times of economic hardships, disposable income is negatively affected and the response tends too be a decrease in consumption. For restaurants this means that changes to tax and interest rates changes in labor market growth and increasing gas prices leads to more subdued growth in household incomes decreasing consumer expenditure on take-out food. More people choose to eat home-cooked meals instead of going out to eat and when they do go out to eat, average consumers are more likely to purchase lower-priced items. Potbelly faces a particularly higher risk because they have a higher price point than restaurants like McDonald's that have value menus.

- *Real estate costs*

  Identifying and securing an adequate supply of suitable new sites presents significant challenges because of the intense competition for those sites in target markets, and increasing development and leasing costs. This may be especially true as Potbelly continues to expand into more urban locations. Further, any continued restrictions of credit markets may require developers to delay or be unable to finance new projects.

Delays or failures in opening new restaurants due to any of the reasons set forth above could materially and adversely affect Potbelly's growth strategy and their expected results. Moreover, as they open and operate more stores their rate of expansion relative to the size of stores will decline, which may in turn slow our sales and profitability growth.

- *Rising food costs*

  Food prices rose 0.4% in February, the most since September 2011[11]. Droughts, unusually cold winter weather, rising exports and a virus outbreak in the hog population are among the causes of food inflation, which is expected to accelerate in 2014. The United States Agriculture Department expects grocery store prices to increase as much as 3.5% in 2014, up from 0.9% last year. Among the foods most affected is beef. The average retail cost of fresh beef last month was $5.28 a pound, up from $5.04 in January and the highest on records dating to 1987.

  Potbelly's profitability depends in part on their ability to anticipate and react to changes in food and supply costs. In the past, they have generally been able to recover inflationary cost and commodity price increases for, among other things, fuel, proteins, dairy, produce, wheat, tuna, and cream cheese through increased menu prices. There have been, and there may be in the future, delays in implementing such menu price increases, and economic factors and competitive pressures may limit their ability to fully recover such cost increases[12].

- *Rising employee expenses*

  Due to the Health Reform Act, Potbelly will have to offer health insurance coverage to more of its employees. Currently they offer eligible full-time and part-time U.S. employees the opportunity to enroll in healthcare coverage that they subsidize. Over the years Potbelly has not had many eligible employees participate in their healthcare plans. However, changes to the U.S. healthcare laws that become effective in 2014 have lead some eligible employees who currently do not participate in their healthcare plans to enroll for coverage. Such changes in the law include the imposition of a penalty on an

[11] Bureau of Labor Statistics
[12] Potbelly Annual 10K

individual who does not obtain healthcare coverage and provisions making certain individuals who can obtain employer coverage ineligible for healthcare premium tax subsidies that would otherwise be available in connection with the purchase of coverage through an exchange. If a significant number of eligible employees who do not currently participate in Potbelly's healthcare plans, or who currently participate in their lower cost limited coverage plan, choose to enroll, healthcare costs may increase significantly and negatively impact Potbelly's financial results

- *Poor initial performance of new restaurants*
  Historically, many of Potbelly's new restaurants have opened with an initial ramp-up period typically lasting 24 months or more, during which they generated sales and income below expected levels. This is in part due to the time it takes to build a customer base in a new area, higher fixed costs relating to increased labor and other start-up inefficiencies that are typical of new restaurants, and a larger proportion of recent openings being in higher rent sites than have been historically targeted. It may also be difficult to attract a customer base if Potbelly is not able to staff restaurants with employees who perform to high standards. New restaurant development activity has broadened recently to incorporate trade areas or restaurant sites in which we have little or no prior experience, including smaller or more economically mixed communities, highway sites, outlet centers, and restaurants in airports and food courts. The risks relating to building a customer base and managing development and operating costs may be more significant in some or all of these types of trade areas or restaurant sites.

RECOMMENDATIONS

Customer Loyalty Program

The highlight of Potbelly's lack luster performance in the recent financial year has been its price driven revenue growth, a trajectory that is not sustainable because of the decrease in the actual number of entrees ordered at Potbelly. Further competition means that Potbelly would not only have to turn its attention to increasing foot traffic into its existing stores but focus on customer engagement as well. DangerZone recommends that Potbelly establish a customer loyalty program to increase customer engagement. This recommendation is based on what we have determined to be a strategy that is currently working very well for its competitors and one that fits perfectly into Potbelly's business model. According to research a large percentage of frequent fast casual diners would make use of rewards programs (See Table 4). Our proposed program would be strongly supported by Potbelly's impressive pre existing technology, social media platforms and what appears to be a strong accompanying customer demand for such a program.

Table 4: Survey Results 2013

	All Adults	Age 18-34	Age 35-44	Age 45-54	Age 55-64	Age 65+	Children under
Use Rewards or special deals	50%	70%	58%	47%	39%	20%	65%
Look up locations or directions on a smart phone	67%	88%	78%	63%	60%	31%	80%

Source: restaurant.org

Our proposed customer loyalty program, Potbelly Gold, is an automatic rewards program focused on customer engagement and data generation. Additionally, it is structured to easily facilitate any future decisions to expand the program or combine with a partnership program. At the very least the program will be able be able to collect data to generate three key metrics for data analysis-loyalty program engagement, customer retention ratio, marketing efficiency ratio. We believe these metrics are important to Potbelly's strategy and operations.

The importance of a customer loyalty program to Potbelly cannot be understated. Marketing analysts estimate that repeated customers could generate between 5 to 15 times revenue for the business than first time or one-time buyers alone[13]. It is important to understand that for customers it is often a challenge to find a restaurant they trust and once a first time customer has a positive experience they are willing to come back for more. Popular loyalty programs, such as point systems, complimentary items, invitation-only events, partnerships with other companies to provide diverse offers and many others, have been shown to lead to successful retention of customers. There is ample evidence that not all customers are equal – loyal customers are far more profitable. Research has demonstrated the powerful economic benefits of increasing customer retention across multiple industries, product and service companies. Concentrating management's attention on attracting and maintaining loyal customers is crucial for businesses to succeed in today's competitive world. Even small changes in customer retention rates and spending levels of loyal customers can have a very big impact on companies' bottom lines. Also, transforming customers into staunch "undying" fans of your business – referring others to become loyal customers too – can turbo-charge profitability as well. In summary the primary economic benefits of Potbelly Gold include:

- Reducing customer loss to maintain profit base
- Increasing the amount spent by loyal customers over time
- Increasing profits as customer service costs decrease
- Increase profits as rewards programs induce customers to purchase higher margin menu items
- Increase profits through referrals

Under Potbelly Gold, customers will earn points for each dollar spent. When a defined threshold is met, the points are converted into a reward. After earning the reward, the point values are reset to zero and customers will begin to earn points toward their next reward. Potbelly customers will earn rewards based on registration in the program and purchases within Potbelly stores. An important aspect of this program would be the limited validity period of Potbelly Gold points. We recommend that fully earned Potbelly rewards should generally expire if unredeemed after 60 days. Partially earned awards should generally expire if inactive for a period of one year.

[13] Customerloyaltyprogram.com

Rewards should be designed to surprise and delight customers through a combination of product or item rewards and unique experiences that only Potbelly can provide. After taking a look at Potbelly's product line we believe the Potbelly signature cookie and hot pepper jars combined with great menu discounts are ideal reward items. Alternatively, under our recommended program, Potbelly can choose to offer guests unrestricted freedom to spend reward dollars however this should allow for the redemption of low margin items in order to keep costs down. In addition to rewarding customers for purchases, the program should also reward customers for recommendations.

In the spirit of Potbelly's commitment to community service, DangerZone proposes a tweak to the traditional rewards program. Included in Potbelly Gold is an option to donate rewards to community charities. Customers would be given the option once they reach a certain number of points to donate those rewards to a local charity. Alternatively rewards could be given towards sandwich donations for local food banks. These can be combined with a commitment by Potbelly to match donations and can be structured around Potbelly's own charitable giving activities. This would be a great way to emphasize Potbelly's brand image and distinguish them from competitors.

In creating this loyalty program, we find it very important for Potbelly Gold to generate data and track benefits and efficiency. This might be challenging especially if the Potbelly decides to add other layers to our proposed basic rewards system. However, at the core of any loyalty strategy, Potbelly would need to ensure that it keeps track of the benefits and efficiency of its program. As part of our recommendation we would advise that Potbelly' program, at the least, keeps track of three metric that we believe are essential to its business model

Loyalty Program Engagement:

This metric allows Potbelly to measure and understand how many customers are actually using the Potbelly Gold program. This could be achieved via integrated analytical systems.

Customer retention ratio:

This metric will give Potbelly access to overall customer loyalty views. The importance of this metric would be in the relative comparison: ratio of customer retention before, and after introduction of the new loyalty program.

Marketing efficiency ratio:
This allows Potbelly to measure the volume of new customers coming through the promotional effort of existing customers. This ratio is likely to go up when Potbelly offers high quality products combines with strong elements of engagement as well as rewards.

In rolling out Potbelly Gold, our recommended strategy is to begin with a pilot in select Potbelly stores. This would enable Potbelly to gauge interest and address any problems that might arise before making it available to stores nationwide. Any plans for marketing should emphasis the value and experience that Potbelly Gold provides as well the unique opportunity for customers to donate their rewards to great community development programs.

Continued Focus on Strategic Expansion
Potbelly is currently operating in diverse markets in 21 states and the District of Columbia. DangerZone recommends that Potbelly focus its attention on building company-operated shops and franchised businesses in both new and existing markets by utilizing a strategic site selection process that works for their business model. An analysis of Potbelly's most successful locations shows that the brand, known predominantly as a good lunch option tends to do very well in neighborhoods with very high daytime population, site visibility, traffic and accessibility. This location-specific approach to development would allow Potbelly to leverage its versatile shop format, which does not have standardized requirements with respect to size, shape or location, to achieve strong returns across a wide range of real estate settings. In 2011, 2012 and 2013, Potbelly opened 21, 31 and 34 new company-operated shops, respectively, and expanded into New York, Seattle, Boston, Phoenix, Cleveland, Kansas City, Portland, Oregon and Hartford, Connecticut. In those same time periods, Potbelly closed five shops, one shop and two shops, respectively, due to underperformance or lease expirations.

Their growth strategy includes plans to open new "hub" markets every year-and-a-half or two years. The rationale is that these areas would give the business a way to reach further into new regions using "spoke" markets that extend from the hub. Additionally, Potbelly seems to be expanding its franchising unit with the aim of attracting additional expansion capital and also expanding within the Middle East. DangerZone sees some potential problems with these growth trajectories and would recommend an evaluation of Potbelly's hub and spoke strategy with expansion to Florida, a commitment to decrease its very high initial investment for franchisers and halted international expansion to enable maturity in Middle Eastern Markets.

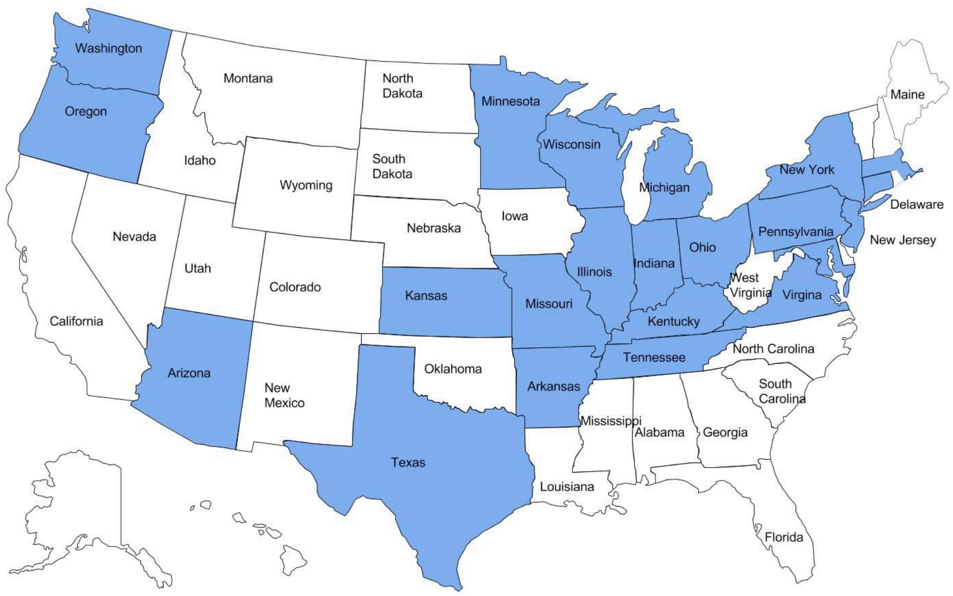
- *Domestic Expansion*

  Potbelly, since its creation, has been known as the Midwest sandwich chain. This is however changing as Potbelly looks to expand westward. DangerZone recommends that Potbelly pair its westward expansion with even more expansion in the east. Familiar markets and a tried and tested business model might lead to quicker and higher returns for the sandwich chain. Based on the target demographics we recommend that Potbelly make a strategic move Orlando, Florida with a long-term goal of further expanding within those regions and eventually to Georgia if an opportunity presents itself.

Table 5: Breakdown of Potbelly Operations by State

Location	Number of shops	Location	Number of shops
Illinois	87	Massachusetts	87
Texas	43	Washington	43
District of Columbia	21	Oregon	21
Maryland	19	Indiana	19
Michigan	19	Pennsylvania	19
Virginia	17	New Jersey	17
New York	16	Connecticut	16
Minnesota	15	Kansas	15
Ohio	14	Kentucky	14
Wisconsin	9	Missouri	9
Arizona	6	Tennessee	1

Figure 2 **States where Potbelly currently operates**



Florida presents a market fueled by health conscious consumers and a bustling tourism industry. Industry reports show that Florida's restaurants particularly in Orlando are expected to be very busy this year and even busier in the future. Sales are projected to reach $4.6 Billion up from $33.2 billion in 2013 while national numbers have dropped, going from a per-person yearly average of 195 meals in 2012 to 192 in 2013 (down from a peak of 215 in 2000). In part, this boom has been attributed to visitors fleeing winter's grip in Midwest and North West regions Florida's economy in 2014 is leading the nation in job growth and the overall recovery, despite once being a straggler. In South Florida, employment is expected to grow 2.3 percent each year and unemployment to moderate to an average of 5.7 percent. The average annual wage is forecast to grow by 2.9 percent to $55,200. Expanding to Florida would not only present an opportunity to capture market share but also help diversify some of Potbelly's geographical risk without moving too far away from its comfort zone. The cosmopolitan and tourist nature of Orlando and Florida in general would also contribute to improving Potbelly's brand recognition globally.

- *International Expansion*

  Potbelly is not very clear on what its international expansion strategy is. As of December 29, 2013, Potbelly in partnership with Alshaya operated 12 franchised shops in Kuwait, the United Arab Emirates and Bahrain and has exclusive franchising rights in the Middle East. This agreement with Alshaya provides that Alshaya may also open shops in Egypt, Jordan, Lebanon, Oman, Qatar and Saudi Arabia. In the short term DangerZone recommends that Potbelly limit its international expansion to the Middle East in lieu of domestic expansion and establishing a strong brand in existing international locations. The fast casual sandwich model is not one that can be successful replicated in many international markets and we recommend that thorough research be done in moving forward with any international expansion strategy.

- *Franchising*

  While franchising is currently only a small part of the Potbelly story," DangerZone believes that a faster pace of franchise growth- 20% of total operations in the next five years- can provide the company with a profitable revenue stream, as well as an opportunity to reach additional lower-priority markets more quickly than through company-operated growth alone. In addition, Dangerzone recommends that Potbelly strengthen its current franchising program through reduction in required initial investment and increased financial support by partnering with Franchise America, a small-to- middle market commercial franchise finance firm specializing in debt and equity placement. Finally, Potbelly should incorporate multi unit franchising in its franchising program to cut down on search and sign up costs and take advantage experienced successful Franchisees,

Figure 3: Current states where Potbelly franchising is available.

DangerZone's recommendation to increase franchise driven growth is based on what is believed to be the ideal proportion of franchises for financial performance in the US restaurant industry - between 30 and 46% of total company operations (Hsu and Jang 2009). Potbelly is currently very well below that. Franchising would of course need to be exercised with caution, hence our recommended 20 % target in five years with an evaluation at the end of this period. With regard to strategy, franchisors perform better financially if they align their franchise proportion with their financial and marketing strategies (Srinivasn 2006) and do not use franchising as a strategy to gather resources, as such an approach has been seen to prevent a proper fit between on the one hand proportion and on the other hand business format characteristics and geographical dispersion of units.

Potbelly should provide stronger financial assistance and support for potential franchisees. Potbelly franchisees have traditionally experienced difficulty accessing the financial and management resources that they need due to high franchising costs and lack of Franchisor support. Financing from banks and other financial institutions is not always available to franchisees to construct and open new shops and this could adversely affect the number and rate of new shop openings by franchisees and future franchise revenues. These are common difficulties for other competitors, however Potbelly provides nowhere near the support that its competitors provide their franchisees. Potbelly can take a similar approach by partnering with a franchise financer to provide greater financial security for franchisees.

DangerZone would like to recommend Franchise America Finance, a well know franchise financer, to provide financing for new franchisees and existing franchisees that want to renovate. Our recommendation is based on Franchise America's commitment to providing quality service to company's similar in size to Potbelly. They have successfully served as financer's for well-known brands like The UPS Store, Carls Jr. and Togo's, a west coast sandwich shop founded in 1971.In the industry of Franchise financers they have established a strong reputation for a business model that is flexible to franchise needs of its customers. Under this partnership, Potbelly would be able to provide its franchisees with the Finance America promise- fast, reliable and specialized loan service.

Development costs can be drastically cut down through savings in construction, interior development and furnishing which currently makes up about 50% of the total franchising development cost. Centralizing the supply of the construction and furnishing items can do this. Currently, each store's furnishings are provided by individual outside suppliers, which tends to push up prices.

Table 6: Table showing Franchising Costs in Select Fast Casual Chains

Franchise Name	Franchise Fee	Royalty	Development Costs
Potbelly	$40,000	7% of gross	$461,000-$761,000
Subway	$15,000	8% of gross	$85,000-$315,000
Quiznos	$25,000	7% of gross	$24,000-$241,000
Jimmy Johns	$20,000	6% of gross	$194,600- $416,900

DangerZone recommends that Potbelly consolidate its supply chain by signing longer-term contracts that would bring in cost savings through discounts. This would reduce the number of single item purchases done during the construction process and drastically cut down on costs.

As of now, Potbelly's franchise model within the United States is mainly based on a single unit model. Interests to include a multi unit franchise system have been expressed by Potbelly management and DangerZone would recommend that Potbelly go through with implementing a multi-unit franchise system for locations with more than one Potbelly alongside its single unit model. This would benefit Potbelly because it can grow more easily through the re-use of existing franchisees. Moreover, multi-unit franchisees make the system more effective by facilitating efficient system-wide adaptation because franchisors have to persuade fewer franchisees to implement changes. Additionally, Potbelly currently has a very strong selection process that can reduce the risk of ending up with an incompetent franchisee.