Cosi, Inc.

Nasdaq: COSI

Improved visibility, reiterate rating

Cosi is a fast casual restaurant with high-quality flat bread

3Q14 Results:

Weak revenue trends for 3Q14 remain company specific issues given declining company-owned comparable restaurant sales of 1.5% YoY (vs. peers PNRA, PBPB, and NDLS of +2.1%, +0.5%, and +1.6%, respectively), due to 2.2% decrease in traffic, offset by 0.3% increase in average check. We believe the main issue for Cosi has been customer service.

Cosi's franchises continue to outperform the company owned stores in same-store sales numbers (-0.8% vs. -1.9%). However, the CEO's option to sell his 14 locations at Hearthstone to Cosi for stock will likely be executed between 4Q14-1Q15 and impact the financials by 1Q15-2Q15. Going forward, investors should focus on company owned numbers excluding hearthstone to see if the CEOs efforts are impacting system-wide stores.

Forward Looking Takeaways:

Management expects 4Q14 company-owned comps of 2.9% **YoY** compared to consensus estimates at PNRA, PBPB, and NDLS of +3.0%, +2.3%, and +1.5%, respectively**.** This is the first positive comp for the company in a long time, and if achieved would be viewed favorably by the market.

We continue to remain positive on management's operational focus of Employee incentives, technology upgrades, and reimaging existing stores (55 units).

Surprisingly, management issued 2015 guidance of $90 to $100M; which includes the expected hearthstone acquisition and assumes AUV of $1.5M and SSS of 5-10%. Excluding hearthstone ($1.7M x 13=$22M, 20-24M range), our estimates for 2015 of $70.6M imply organic revenue declines of 10% (due to less units).

We reiterate our neutral rating as we believe that the new CEO should have a favorable impact on the turnaround of urban stores, however, are concerned about his impact on suburban stores, further shareholder dilution, and the amount of time it will take the company to turn around. However, visibility is improving with management initiating guidance and additional details. Further, we have a neutral rating and price target of $1.55, based on NTM P/S of 0.6x, comparable to peers.

Rating	**Neutral**
Risk Rating	**Speculative**
Current Price (Nov 18, 2014)	**$1.65**
2014 Price Target	**$1.55**
Implied Takeover Premium	**0%**
Projected total return	**-6%**
Shares outstanding (M)	25
Market capitalization (M)	$41.3
Long term debt (MRQ)	$6.7
Cash (MRQ)	$6.1
Enterprise value	$41.9
2015 P/S	0.6x
Average daily volume (3 m)	290,000
Float as % of shares out.	67,6%
Short interest as % of Float	8%
Insider ownership	31%
Institutional ownership	15%
Tangible book value p/s	($0.12)
Cash/share	$0.24

Revenue (M)

	2012	2013	2014E	2015E
Q1	$24.7	$20.9	$18.4a	$23.5
Q2	$26.3	$22.7	$20.7a	$25.6
Q3	$24.4	$20.6	$19.2a	$23.6
Q4	$22.6	$19.0	$19.5	$22.9
FY	$98.0	$86.3	$77.7	$95.6

EBITDA (M)

	2012	2013	2014E	2015E
Q1	($0.2)	($2.0)	($2.5)a	$0.0
Q2	$1.0	($1.5)	($4.0)a	$0.4
Q3	($0.4)	($1.8)	($3.2)a	$0.3
Q4	($1.2)	($3.0)	($1.4)	$0.3
FY	($0.8)	($8.3)	($11.2)	$1.0

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Investment Thesis:

The success of COSI depends on its ability to turn around suburban stores, an area where the company continues to struggle; further, we expect the main factor will be the effectiveness of COSI's new marketing strategy directed to suburban locations. Given RJ Dourney's (CEO) expertise is in operating urban areas, and specifically improving the stores customer traffic (throughput), we expect Cosi's 40 "urban" locations will be the ones that benefit most from his operating experience. Moreover, his units' above-average performance ($1.7M AUV 20%+ EBIT margins vs. company-wide: $1.2M and -8%) are proof that RJ can operate urban stores successfully. However, we remain concerned that the store may not be a good model for suburban areas, and further are skeptical that a new marketing strategy will improve the stores in these locations.

S**hareholders may face more dilution risk (13M+ shares) as cash burn trends remain significant, current management is mostly compensated with stock, and a capital raise will occur soon.** The company will likely do a right's offering, like in 2012, when they raised $12.8M out of an available $15M. Cash burn remains elevated given cash burn for each of the past three quarters was $3.2M, $3.9M, and $4.4M respectively (vs. $3.8M/yr average in past). In addition, RJ has an option to sell his 14 locations at Hearthstone to Cosi in exchange for stock, which may go through in 4Q14-1Q15 and have an impact on the financials by 1Q15-2Q15.

In the face of a declining business, we find it encouraging that the new CEO, RJ Dourney, continues to make operational changes. Key changes include: Closing company-owned stores and converting some franchises to company-owned stores (63 company-owned and 47 franchises remain), assembling a new management team while relocating the headquarters, focusing on employee incentives (stock-based for management and EBITDA at the store level), and improving technology and service speed; all of which are encouraging to the potential turnaround of the brand.

 November 18, 2014

Appendix:

A. Income Statement

INCOME STATEMENT	1Q13	2Q13	3Q13	4Q13	1Q14A	2Q14A	3Q14A	4Q14E	1Q15E	2Q15E	3Q15E	4Q15E	2013A	2014E	2015E
Company-owned	20.9	22.7	20.6	19.0	17.7	20.0	18.6	18.6	17.3	19.4	17.3	16.6	83.1	67.7	70.6
Franchises	0.7	0.8	0.8	0.9	0.6	0.7	0.6	0.9	0.6	0.7	0.7	0.8	3.2	2.9	2.9
Revenues	21.6	23.4	21.4	19.9	18.4	20.7	19.2	19.5	23.5	25.6	23.6	22.9	86.3	77.7	95.6
Cost of food and beverage	5.2	5.5	5.2	4.8	4.4	5.1	5.1	4.9	5.8	6.4	5.8	5.7	20.7	19.5	23.7
Restaurant labor	8.1	8.2	8.2	7.9	7.1	7.4	7.1	6.8	8.1	8.7	7.9	7.6	32.4	28.5	32.3
Occupancy and other	7.1	7.5	7.2	7.1	7.0	7.1	6.8	6.4	7.0	7.7	7.1	6.9	29.0	27.3	28.7
COGS	20.5	21.2	20.6	19.8	18.5	19.6	19.0	18.1	21.0	22.7	20.8	20.1	82.1	75.3	84.6
Gross Profit	1.1	2.2	0.8	0.1	(0.1)	1.0	0.2	1.4	2.5	2.9	2.8	2.8	4.2	2.5	10.9
Gross Margin	5.1%	9.3%	3.9%	0.6%	(0.7%)	5.0%	1.0%	7.0%	10.7%	11.2%	11.7%	12.2%	4.9%	3.2%	11.4%
SGA	2.8	3.1	2.6	3.1	2.4	3.7	3.1	2.6	2.3	2.3	2.3	2.3	11.1	11.8	9.0
Operating expenses	0.4	0.5	0.0	0.0	(0.0)	1.4	0.3	0.2	0.2	0.3	0.2	0.2	0.9	1.9	1.0
EBITDA	(2.0)	(1.5)	(1.8)	(3.0)	(2.5)	(4.0)	(3.2)	(1.4)	0.0	0.4	0.3	0.3	(7.7)	(11.2)	1.0
EBITDA margin	(9.3%)	(6.3%)	(8.2%)	(15.1%)	(13.6%)	(19.5%)	(16.8%)	(7.4%)	0.1%	1.4%	1.2%	1.4%	(9.0%)	(14.4%)	1.0%
Depreciation	0.7	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.7	0.8	0.7	0.7	2.6	2.4	2.9
Amortization of intangibles	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
EBIT	(2.8)	(2.1)	(2.4)	(3.7)	(3.1)	(4.6)	(3.8)	(2.0)	(0.7)	(0.4)	(0.4)	(0.4)	(10.3)	(13.6)	(1.9)
EBIT margin	(12.8%)	(9.1%)	(11.3%)	(18.5%)	(17.0%)	(22.4%)	(19.8%)	(10.4%)	(2.9%)	(1.6%)	(1.8%)	(1.6%)	(12.0%)	(17.5%)	(2.0%)
Non-oper expenses	0.0	0.0	0.0	(0.5)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	(1.1)	0.0	0.0
Gain (loss) on asset sales	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest Income	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest expense	0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.2	0.2	0.8	0.2	0.8	0.0	0.8	2.1
EBT	(2.7)	(2.1)	(2.5)	(3.2)	(3.1)	(4.8)	(4.1)	(2.3)	(0.9)	(1.2)	(0.7)	(1.2)	(9.2)	(14.4)	(4.0)
EBT margin	(12.7%)	(9.1%)	(11.5%)	(16.0%)	(16.9%)	(23.2%)	(21.3%)	(11.7%)	(3.9%)	(4.8%)	(2.9%)	(5.2%)	(10.7%)	(18.6%)	(4.2%)
Provision for taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Equity earnings in affiliates	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Minority interest in earnings	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Income	(2.7)	(2.1)	(2.5)	(3.2)	(3.1)	(4.8)	(4.1)	(2.3)	(0.9)	(1.2)	(0.7)	(1.2)	(9.2)	(14.4)	(4.0)
Net Margin	(12.7%)	(9.1%)	(11.5%)	(16.0%)	(16.9%)	(23.2%)	(21.3%)	(11.7%)	(3.9%)	(4.8%)	(2.9%)	(5.2%)	(10.7%)	(18.6%)	(4.2%)
WACSO	18.0	18.0	18.0	18.0	17.8	18.1	20.3	32.8	32.8	32.8	32.8	32.8	18.0	22.3	32.8
EPS	($0.15)	($0.12)	($0.14)	($0.23)	($0.17)	($0.27)	($0.20)	($0.07)	($0.03)	($0.04)	($0.02)	($0.04)	($0.63)	($0.71)	($0.12)

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