

**UNIVERSITY OF MISSOURI-
ST. LOUIS**

MAKING SENSE OF INVESTING

Symbol:	NYSE: BBW
Rating:	HOLD
Suitability:	Small-Cap Growth
Date:	July 21 th , 2008
Price:	\$6.69
Dividend:	N/A
Yield:	N/A



Stock Report

BUILD-A-BEAR

WORKSHOP

Retail (Specialty)

Company Overview

Founded in 1997 by Maxine Clark, Build-A-Bear Workshop ("Build-A-Bear") has more than 375 teddy bear themed stores around the world. Build-A-Bear became a publicly traded company in October 2004. Their mission is to bring the teddy bear experience (love, friendship, and security) to life through an interactive and entertaining retail experience where Bear Builder associates guide customers of all ages through the process of creating a fluffy new friend. Revenue for 2007 was \$474.4 million, up 8.5% over the prior year.

Market Data

52-Week Range	\$5.61-\$25.97
Market Cap.	\$125.0M
Div. Pmt. Mths	N/A
Est. Engrs Date	Jul 24th, 2008

Valuation

	07A	08E	09E
Earnings	1.10	0.71	0.80
P/E	6.1x	9.4x	8.4x
PEG	0.6x	0.9x	0.8x

Growth Outlook

Est. 5-Yr. EPS Growth	10%
Est. 5-Yr. Rev Growth	23%
Est. 5-Yr. Div Growth	N/A

Financial Data

% Rev Int'l	12%
Debt Rating	NA

Companies with international exposure have special risks including those related to currency fluctuations and political and economic events.

INVESTMENT SUMMARY

Rating: **HOLD.** Build-A-Bear is recommended as a HOLD for investors seeking small-cap growth. While the balance sheet and cash position remain strong for a retailer given the current economic conditions, there is concern around declining sales in established stores evidenced by the negative comparable store sales. Build-A-Bear revealed an innovative initiative in the online interactive world through Build-A-Bearville.com, but additional transparency is needed on Build-A-Bear's long-term growth and online strategy.

Favorable view of Build-A-Bear

Build-A-Bear introduced an interactive virtual world called Build-A-Bearville.com at the end of December 2007. This innovative initiative broadens the company's foundation for other entertainment oriented areas. Build-A-Bearville.com is free to sign-up, but when customers purchase new stuffed animals, they are able to access exciting new online places and games. Another goal of the online world is to utilize the virtual site to bring customers into the real stores for additional purchases. At the end of April 2008, there were over 3 million online characters created.

Build-A-Bear has also become a collaborative partner of Ridemakerz, a private company with another retail entertainment idea. Ridemakerz is an interactive retail experience of building customized toy and remote control cars which targets boys and families. Build-A-Bear invested over \$2 million in Ridemakerz at the end of April 2007 giving Build-A-Bear approximately a 33% equity stake in the privately held company. Ridemakerz was named the hot new retailer of the year by International Council of Shopping Centers.

Expected Continued Concern: Product Cycle

The main concept and product for Build-A-Bear is the personal experience of building a stuffed animal with clothing and accessories. New animal skins and accessories are being developed as well as movie characters ("Happy Feet") and TV characters

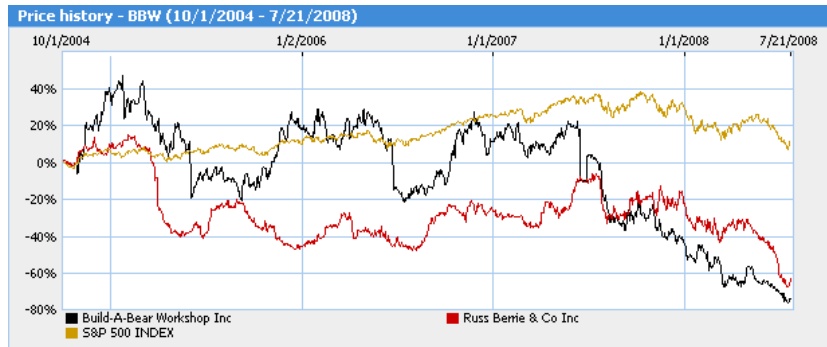
(“Hannah Montana”), however, there is concern over the interest remaining strong with the build a bear experience. Revenue has increased 8.5% over the prior year, but profit has decreased 23.5%.

Same Store Sales Plunge Raising Long-Term Growth Questions

A key indicator of health for the retail sector is same store sales which measures the sales results for stores open more than thirteen months of operation. During the first quarter 2008, Build-A-Bear’s North American same-store sales comparisons declined 13.1% from the first quarter of the previous year. Build-A-Bear emphasized that the decrease was primarily due to macroeconomic conditions slowing discretionary spending and mall traffic, in addition to changes in entertainment trends toward online activity. There is also concern that new store openings are stealing business from established stores leading to the negative same store sales. I project the same store sales to continue to decline for 2008, but at a slower percentage given the recent efforts of Build-A-Bearville.com to enhance store sales and their initiatives towards customer loyalty and slowing the increase in number of stores.

Valuation

Since the IPO in October 2004 when the offer price was \$20.00, the stock price has declined into the single digits. Build-A-Bear currently trades at 6 times the fiscal year 2007 actual EPS of \$1.10. Compared to Russ Berrie and Company (RUS), a specialty competitor, at \$0.93 EPS, Build-A-Bear Workshop’s EPS is favorable. Furthermore, the PE ratio is low compared to other growth companies meaning the stock may be undervalued, but most likely since it is extraordinarily low; investors have concerns about the ability of their business model to maintain strength and grow profits. This concern is justified by the decrease in net income over the past three years and projections of EPS decreasing over the next two years. Build-A-Bear has a very low PEG ratio. A PEG ratio below 1 also indicates that the stock may be undervalued or that investors have concerns about the long term growth. Regardless, market interest in Build-A-Bear’s has stayed fairly constant over the period reviewed with trading volume of approximately 300,000 shares per day. There were over 3.6 millions shares shorted according to Yahoo Finance, which is down approximately 200,000 from the previous month. This suggests a more favorable sentiment could be on the horizon. Cash is high and they are debt free, but this has failed to excite investors. The market has been bearish to the Build-A-Bear stock overall and is pricing in substantial risk to future earnings.



Risks

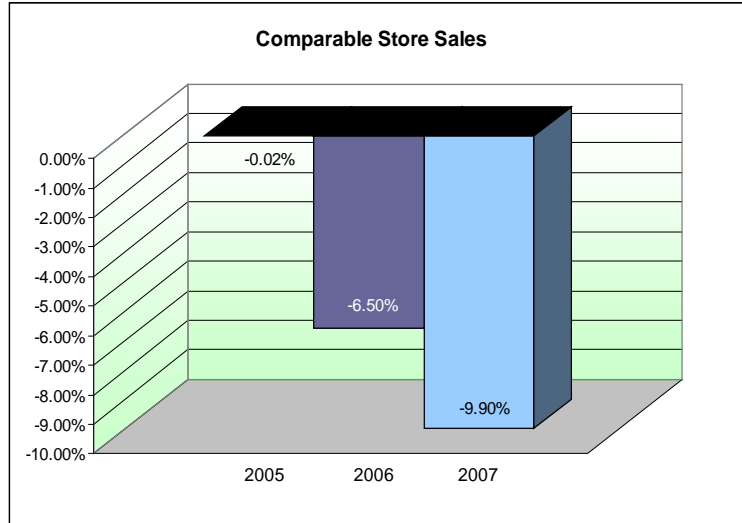
The key risks facing Build-A-Bear are the macroeconomic environment which is decreasing the discretionary dollar for specialty retail spending. In addition, mall traffic across the United States is deteriorating which is a primary location for Build-A-Bear Stores.

The weak United States dollar reveals the risk of fluctuating and increasing costs for inventory produced overseas in China. (84% of Build-A-Bear inventory was produced in China in 2007). Also, fuel price increases further squeeze profit margins due to increased costs of shipping inventory. The limited company vision, limited

product concept, and instability of the product market lead to uncertainty in the longevity of sales.

RECENT NEWS AND ANALYSIS

On April 24th, 2008 Build-A-Bear reported first quarter 2008 results with overall revenue of \$123.8 million, an increase of 6% from first quarter 2007, and EPS of \$0.32, decreasing 21% from first quarter 2007. Even though earnings declined, the company did beat analysts' expectations of "27 cents per share on revenue of \$121 million". [1] A key financial health focus for the retail sector is comparable store sales. Comparable store sales decreased 13.1% in North America compared to negative 6.9% in first quarter 2007; but comparable stores sales increased 14.5% in Europe. Build-A-Bear reaffirmed previously announced plans of slowing new store openings in 2008. In 2008, the company plans to open a total of 25 new company-owned stores in North America and Europe compared to 50 new stores in 2007. [1]



Maxine Clark, CEO, attributes lower financial results to "general declines in shopping-mall customer traffic and consumer discretionary spending; changes in the way children, especially girls, play and consume media and online entertainment; and poor sales of licensed movie products" such as "Shrek's." [12] However, some investors are concerned that declines are due to new stores cannibalizing older stores and the concept losing originality. Others believe, such as analyst Rob Furlong, of Baltimore-based Garp Research & Securities Co., that their product is a slowing fad that was magnified only by Ms. Clark's appearance on the "The Oprah Winfrey Show." in February 2004. On the positive side, Garp's Research also indicated "Fundamentally they have a great business model in retail entertainment and less inventory risk than most merchandisers." [10] Other credit analysts companies such as Credit Suisse have also downgraded the stock due to "macroeconomic weakness will continue to pressure comparable (comps) store sales and margins in the foreseeable future." [9] Build-A-Bear just needs to leverage their model to gain profitability and new initiatives for future sales growth.

Recent news according to *Business Week* indicates that Build-A-Bear is staying on top of new trends and hot items. Hello Kitty was introduced in May 2008. Build-A-Bear also tied the new product to www.buildabearville.com by giving Bear Bills (used in the virtual world), an extra room and Hello Kitty Wallpaper for their Cub Condo House, and a virtual Hello Kitty tee for their furry friend. Build-A-Bear is also partnering with The Game Factory to publish a game for the Nintendo Wii. This will be a family-friendly game where players can participate by "personalizing their own furry friend, playing the mini games for medals, experiencing adventure

mode, and using the medals to 'purchase' more outfits and accessories." [5] The Wii operated remote will also be used for sack races or jumping on a trampoline.

INDUSTRY AND COMPANY OUTLOOK

Virtual Entertainment Growth

The teddy bear is a classic icon and Build-A-Bear's unique interactive experience centers on the classic icon. However, the Build-A-Bear concept has been around for more than 5 years, so in order to continue business growth Build-A-Bear is going to have to explore more business and product initiatives. Build-A-Bear recently introduced Build-A-Bearville.com at the end of December 2007. Build-A-Bearville.com has exciting new online places and games are accessible for free. At the end of April 2008, there had been over 3 million online characters created. The virtual site has already shown potential growth for the company's virtual entertainment area.

As stated in recent news, Build-A-Bear has also scheduled a release in the fourth quarter 2008 for a Wii game incorporating the unique entertainment experience of Build-A-Bear.

The virtual and gaming worlds are in growth, so I see this as a benefit that Build-A-Bear has incorporated this concept into their business strategy and core concept.

Internet and TV Advertising Opportunity

The Build-A-Bear marketing plan targets moms and children and focuses heavily on prime TV spots like "Hannah Montana" and "The Suite Life of Zack and Cody." The new 2008 marketing plan will push Bear-A-Bearville.com. I foresee the opportunity for future advertisement through popular internet sites for kids. Build-A-Bearville.com is also an advertisement in itself if new concepts are brought into the virtual world and customers are told that they can purchase the new items in stores.

Neutral Company Outlook

Build-A-Bear has the opportunity now to re-evaluate their strategic plans for future growth and initiatives. The original core concept may be declining in interest in North America, but is still progressing in Europe. Also, the recent focus to the virtual world and partnership with The Game Factory for the development of Build-A-Bear interactive Wii games has shown the company has many routes in the unique entertainment arena.

Investing For Growth

Build-A-Bear is focusing heavily on virtual entertainment, marketing, and fresh start-up ideas such as Ridemakerz to position itself financially for the future. Build-A-Bear has no debt and significant cash, so they are able to invest in new initiatives. Capital and marketing expenditures are necessary up front to provide the long-term impact. This may be a reason for the decrease in profitability during year-end 2007 and first quarter 2008. However, these investments and expenditures are vital to stay on the cutting edge of entertainment and communicate the unique exciting experiences that kids and families can have by going to a Build-A-Bear store or to the virtual site. I believe that Build-A-Bear will see growth in sales from the virtual site as it appears they have fast growing membership and tactics that require real world purchases to advance in the virtual world. As long as the site is current and innovative, I believe there will be growth in the single digits of revenue.

Dedicated Management Team

The management team at Build-A-Bear has a dedicated work ethic and confidence in their product and company. Company founder Maxine Clark, CEO, has a strong retail background including President of Payless ShoeSource, Inc. and experience in roles merchandise development, merchandise planning, merchandise research, marketing and product development with May

Department Stores. There is also a dedicated management team that appears to be competent of business functions and passionate for the job and product. The management and employees at Build-A-Bear embrace the Build-A-Bear products by keeping stuffed animals around their cubes indicating their support and joy in the product.

FINANCIAL POSITION

I have decided to perform a three year time-series analysis for Build-A-Bear's ratios because it will provide insight to their unique product market. A significant fact to note over this time period is that Build-A-Bear acquired The Bear Factory Limited and Amsbra Limited in the United Kingdom for \$39.4 million. Property, Plant, and Equipment realized a large increase from 2005 to 2006 as a result of this acquisition since 1) Amsbra owned several stores and 2) leasehold improvements were undertaken on the United Kingdom stores to re-brand them.

LIQUIDITY RATIOS			
	2005	2006	2007
CR	1.8X	1.3X	1.4X
QR	1.3X	0.8X	0.9X

The Current Ratio (CR) indicates that Build-A-Bear has liquidity to cover its short-term obligations. The decrease in the CR from 2005-2006 and stabilization in 2007 is expected from the large investment in the United Kingdom acquisitions. Expenditures such as these generally provide higher returns than accumulated cash. The stabilization in 2007 was a good sign that the acquisition did not adversely impact liquidity as their strong cash flow enabled recovery.

To ensure inventory build-up was not a problem, I have calculated the Quick Ratio (QR) which is the same as the CR without inventory, since it is the least liquid current asset. The QR follows the same trend over this time period. This suggests that the declining and stabilizing pattern was not driven by increasing inventory, but rather only from the acquisition.

Build-A-Bear's inventory increased by over 27% in 2006, and only decreased slightly in 2007. Inventory increases traditionally indicate slowing demand or mismanagement of assets. In this case, however, it is likely to be only because of the increase in stores. Build-A-Bear increased the number of stores from 200 to 271 (36%) in 2006, then added another 50 stores in 2007. Nevertheless, inventory management is important to controlling costs. Build-A-Bear does not manufacture their own materials so inventory is maintained at the stores themselves and leasing mall space for inventory can substantially reduce profitability. The inventory accumulation indicates that additional attention needs to be provided by evaluating the firm's efficiency ratios.

EFFICIENCY RATIOS			
	2005	2006	2007
ITO	4.5X	4.5X	5.3X
TATO	1.5X	1.5X	1.4X

The table above shows that the Inventory Turnover ratio (ITO) was constant during the acquisition and increased significantly in 2007. This indicates that the amount of inventory Build-A-Bear has been holding relative to the Cost of Goods Sold has declined. This indicates the firm's inventory management has become more efficient, despite adding several new locations. To compare the efficiency of the inventory use with the increased total assets I have decided to review the Total Asset Turnover ratio (TATO).

The TATO has slightly decreased over the time period indicating the efficiency of the inventory management has not been consistent with the rest of Build-A-Bear's asset management. Build-A-Bear added another 50 stores in 2007 explaining growth across the balance sheet, but amidst the growth they have not

been able to improve on overall efficiency. Although there were increases in receivables, they were in line with the revenue growth in 2007. The asset with the most growth out of proportion to the sales increase was fortunately cash. This is a favorable increase in light of the previous discussion on a need for increased liquidity.

Overall, my opinion on the efficiency of Build-A-Bear is favorable. I would like to see efficiency improvements over the long term to show that the stores are able to become more profitable over time; however, I think the consistency is not bad in light of the many new store openings and complications a major acquisition could have caused.

LEVERAGE RATIOS			
	2005	2006	2007
DR	47%	45%	43%
TIE	N/A	N/A	N/A
EM	1.89X	1.82X	1.75X

Build-A-Bear does not have long term debt. Their liabilities are mostly accounts payable, gift cards, and deferred rent. Over the past three years, Build-A-Bear's Debt Ratio (DR), total liabilities divided by total assets, has decreased consistently. This could be either because of decreasing debt or increasing assets. Similarly, the Equity Multiplier (EM) decreased

consistently over the period indicating a decrease in use of debt to finance assets. Decreasing debt indicates lower risk since the company is not relying on a fixed cost of debt to finance its assets; however, the alternative of financing with equity foregoes favorable tax treatment of interest and will demand a greater return for shareholders.

Build-A-Bear does not have interest expenses since there is no long term debt and accordingly, the Times Interest Earned ratio (TIE) is not applicable.

In order to draw final conclusions about Build-A-Bear's financial health the profitability will be analyzed using the Return on Equity (ROE) and Net Profit Margin (NPM).

PROFITABILITY RATIOS			
	2005	2006	2007
ROE	21%	18%	12%
NPM	8%	7%	5%

The ROE and NPM have been declining significantly over the past three years. The ROE measures the return Build-A-Bear provides on the funds contributed by shareholders so it is crucial to the stock analysis. The DuPont System of Analysis helps to breakdown the ROE pattern to determine if the pattern is created by efficiency, leverage, or profitability.

$$ROE = PM \times TATO \times EM$$

$$ROE = (NI/Sales)(Sales/TA) (TA/EQ) = NPM \times TATO \times EM = NI/EQ$$

The analysis provided thus far has shown that assets have been increasing, debt has been decreasing, and overall efficiency has slowly decreased. None of these anomalies alone provide justification for the drastic declines in ROE. However, when the factors are reviewed in aggregate the concerns become clear:

	ROE	=	NPM	X	TATO	X	EM
2005:	0.21		0.08		1.5		1.89
2006:	0.18		0.07		1.5		1.82
2007:	0.12		0.05		1.4		1.75

As evident above, the ratios combine to create a perfect storm against profitability. The assets of Build-A-Bear have been soaring, while the use of leverage has fallen, this reliance on equity to fund growth demands higher profit. Amidst the challenges of this

capital structure decision came a decrease in the profitability of the businesses themselves. The NPM shows that margins have been falling drastically from rising input costs, a plummeting currency, and slowing comparable store sales. The Cost of Goods Sold has increased 44% over the past three years, while the sales have only increased 31%. Financing growth with current earnings is not a problem, but Build-A-Bear needs to focus the investment on keeping the stores it has profitable before continuing to open new stores. The risks in long-term profitability are only being put further at risk by continuing to open stores under the same model.

On the favorable side, the research I have conducted has shown that Build-A-Bear seems to be shifting focus to other avenues of growth (online entertainment and gaming) that could make the profitability of their current assets increase in the future.

ON SITE INTERVIEW

Review of Physical Site

Build-A-Bear's headquarters is decorated with bright colors and shelved with stuffed animals galore. The employees working at Build-A-Bear headquarters appear to be happy in their work environment. Employees have the work environment flexibility to bring their dogs

into work, but the office is still capacitated after 5:00 showing that the employees are committed to their job responsibilities.

Review of Product

Build-A-Bear's product is a very distinctive entertaining experience. Recently, I went with friends in their mid to late twenties to the Build-A-Bear shop to build a bear. The staff was very friendly and the process to pick an animal skin, stuff the bear, pick clothing for the bear, and name the bear made for a unique, fun afternoon, even for twenty year-olds. The kids in the store appeared to be having a great time making bears and the Build-A-Bear website is filled with positive comments and great experiences when building bears or attending bear parties.

Manager's Insights

I met with Molly Salky, Director of Investor Relations, on July 17, 2008 from 9:00 am to 10:00 am at Build-A-Bear's headquarters in St. Louis, MO to gain insight into Build-A-Bear's stock. I delivered a follow-up 'thank you' note and a copy of the stock report to Ms. Salky on July 22nd 2008.

Q: What are the key challenges you see facing Build-A-Bear over the next three years?

A: A key challenge is the economy's impact on revenues. Customer spending is under a lot of pressure and same store and store sales are declining. This results in pressure to drive profitability, but there are fixed cost components of "rent" and "payroll." When sales come down, we have a hard time managing these costs.

Q: What is the focus of your long term growth strategy?

A: Continuing to offer a unique, highly interactive retail entertainment experience. Long term would be to put things in place with Build-A-Bearville.com to take the brand experience of real world to the virtual world. This is a unique opportunity for guests and fun entertainment will continue in the real and virtual worlds. Also, staying relevant with guests such as offering Hannah Montana or High School Musical bears.

Q: What is the strategic purpose of BuildABearville.com and have you seen increases in sales and profits related to this virtual world?

A: Staying relevant with core guests and be relevant with the virtual world. We are still in the early adoption phase for the site and gaining critical mass. It is difficult to point to gains and sales.

Q: Who would you consider your main competitors to be and how do you believe you perform in comparison?

A: No exact matches. We consider our competitors to be wherever families go to have fun such as movie theaters, amusement parks, miniature golf, and eating out.

Q: How have the acquisitions of BearFactory and Amsbra impacted Build-A-Bear? And what are their remaining potential benefits in the future from this acquisition?

A: Positive acquisitions. In quarter one 2008, the UK stores began to show year over year profitability. UK shows positive comparative store sales. This year we plan opening five new stores in the UK. The theory of acquisition came in our ability to consolidate and unify our brand across the world. In the UK, there was a direct competitor. Since the UK has lease terms of 20 to 25 years, we decided to buy the locations and convert the stores.

Q: Do you believe the new "Stuff for Stuff" program has increased sales in your stores?

A: Difficult to know with precision. This program allows communication directly with the guests. If customers take the time to sign up with the program, this means they want to come back. A best guest comes to the store 3 or 4 times a year. Research shows communication within 3 months, yields higher return rates.

RECOMMENDATION AND CERTIFICATION

Recommendation

The following recommendations are possible:

Buy (B)
Fundamentals and /or Valuations are compelling.

Hold (H)
Fundamentals and/or valuations are stable. Or a special situation exists, such as a merger that warrants no action.

Sell (S)
Fundamentals are deteriorating considerable and/or a recovery is highly unlikely. The stock is significantly overvalued.

Short (SS)
Fundamentals have deteriorated and are expected to continue to do so for the foreseeable future resulting in negative growth in EPS.

I have recommended a HOLD for the reasons outlined in this report.

Certification

I certify that the information contained in this report is the result of my primary research and has not been copied in whole or in part. All sources of information have been properly and completely documented in the *Bibliography*. Statements that are not my own have been put in quotations and are properly referenced in the *Reference* section.

I have read and understand the *University of Missouri* guidelines governing plagiarism and further certify that no statements contained in this report are other than my own. Should the professor find otherwise, I understand that I am subject to the University's rule of suspension or expulsion from the UM system.

Ashley F. Lane

Date signed

Name Printed

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