investors CHRONICLE alpha

26 October 2018

# Phil Oakley's Weekly Round-Up

*This week I assess the effect of Domino's Pizza's expansion strategy on existing franchisees and overall profitability. I also run the rule over Whitbread and Stobart Group*

The companies mentioned this week are:

- Domino's Pizza
- Whitbread
- Stobart Group

## Domino's Pizza

A couple of years ago I would have cited **Domino's Pizza (DOM)** as an example of an outstanding business, albeit with an expensive valuation attached. I used the company extensively in my book *How to Pick Quality Shares* to illustrate the financial characteristics of a high-quality business.

Many of those characteristics – high profit margins, high ROCE (return on capital employed) and good cash conversion – remain, but Domino's is now having to work hard to convince investors that its business model and growth prospects are robust enough. Judging by its share price performance over the past year, it would seem that the company has not been convincing enough.

One of the main concerns is to do with the strategy of opening new stores in existing territories in the UK where there already is a Domino's Pizza store or stores – referred to as splitting territories.

Investors have good reasons to be concerned about this splitting strategy. Whilst opening new stores can lead to higher overall sales for a business, it can damage the profitability of individual stores if the new stores take sales from the existing ones – a process known as sales cannibalisation.

Sales cannibalisation can wreak havoc with a retail or restaurant business. **Tesco (TSCO)** and **Restaurant Group (RTN)** are good examples of this when they opened

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*"As Domino's future growth in the UK is largely down to its franchisees opening more stores, it needs to keep them happy"*

too many new stores next to or near existing ones.

This issue has put Domino's UK in conflict with some of its franchisees. Domino's makes most of its profits from selling pizza ingredients to its franchisees. Opening more stores and growing the number of pizzas sold is likely to be good for its profits. A new store in the same local area might not be so great for a franchisee's profits if it takes customers and sales away from its existing stores.

As Domino's future growth in the UK is largely down to its franchisees opening more stores, it needs to keep them happy.

Let's take a closer look at how Domino's UK makes its money to show how this conflict has arisen and may not go away quickly.

**How Domino's UK & Ireland makes money**

Before we can make a judgement on Domino's UK strategy it won't do any harm to understand how this business makes money.

Domino's owns the master franchises to trade under the Domino's Pizza brand in the UK, Ireland, Switzerland, Norway, Iceland, Sweden and Germany. These master franchises are awarded by the US parent company **Domino's Pizza Inc (US:DPZ)**.

The UK and Ireland is mainly a franchise business where the stores are operated by franchisees as a standalone business. The UK franchising business makes money from the following sources:

- Net royalties: Franchisees pay 5.5 per cent of their sales in royalties to Domino's UK. Domino's UK then pays 2.7 per cent of the system sales (the sales of pizzas from all its franchised and corporate stores) to Domino's Pizza Inc as a fee for the master franchise. Net royalties are therefore 2.8 per cent of system sales.
- Supply chain sales: The sale of pizza dough, other pizza ingredients (such as cheese and toppings) and equipment to franchisees. This is by far Domino's biggest source of profits.
- Rents: Domino's has the lease contracts on all the rented stores in the UK. These are then sub-let to franchisees at cost. Rents are a pass through and are not a source of profits.
- Sales and profits from corporate stores: This is not a large amount of money.

Franchisees also pay 4 per cent of their sales into Domino's national advertising fund (NAF), but this is not classified as revenue since it is operated on a break-even basis. The cash flows are treated as working capital

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with the difference between monies received from franchisees and the amount spent shown on the balance sheet as a debtor or creditor and the annual change as a cash flow in the cash flow statement. The numbers here are not very big.

The profitability of the UK and Ireland business is shown in more detail below:

| UK & ROI Profit (£m) | TTM | H1 18 | 2017 | H2 17 | H1 17 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|---|---|---|---|
| System sales | 1121.8 | 565.1 | 1079.4 | 556.7 | 522.7 | 988.8 | 865.6 | 748.2 | 650.9 |
| Revenue | 418.3 | 212.4 | 393.4 | 205.9 | 187.5 | 345.1 | 305.1 | 279.1 | 250.7 |
| Supply chain revenue | 310.5 | 156.7 | 297.4 | 153.8 | 143.6 | 265.1 | 241.0 | 221.8 | 199.7 |
| Franchisee royalties | 61.7 | 31.1 | 59.4 | 30.6 | 28.7 | 54.4 | 47.6 | 41.2 | 35.8 |
| Royalty paid to DP Inc | -30.3 | -15.3 | -29.1 | -15.0 | -14.1 | -26.7 | -23.4 | -20.2 | -17.6 |
| **Supply chain margin** | **90.0** | **45.5** | **87.6** | **44.5** | **43.1** | **83.3** | **71.3** | **60.8** | **54.6** |
| Net overheads & depreciation | -28.4 | -15.2 | -27.6 | -13.2 | -14.4 | -26.5 | -22.7 | -18.9 | -17.8 |
| Corporate store profits | 1.2 | 0.6 | 0.6 | 0.6 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| UK JV's & Assocs profit | 2.7 | 1.5 | 2.4 | 1.2 | 1.2 | 2.1 | 1.7 | 1.0 | 0.6 |
| **Total UK & ROI operating profit** | **96.9** | **48.2** | **93.2** | **48.7** | **44.5** | **86.6** | **74.5** | **63.8** | **55.6** |
| | | | | | | | | | |
| Op profit as % of system sales | 8.6% | 8.5% | 8.6% | 8.7% | 8.5% | 8.8% | 8.6% | 8.5% | 8.5% |
| Op profit as % of revenue | 23.2% | 22.7% | 23.7% | 23.6% | 23.8% | 25.1% | 24.4% | 22.9% | 22.2% |
| | | | | | | | | | |
| Supply chain as % of revenue | 74.2% | 73.8% | 75.6% | 74.7% | 76.6% | 76.8% | 79.0% | 79.5% | 79.6% |
| Supply chain % margin | 29.0% | 29.0% | 29.5% | 28.9% | 30.0% | 31.4% | 29.6% | 27.4% | 27.3% |

Source: Domino's Pizza

We can see a few interesting things here:
Firstly, the profit margin as a percentage of system sales has been very consistent at around 8.6 per cent for the past few years. This means that there has been a fairly stable relationship between the value of food its franchisees sell and the amount of profit ultimately made by Domino's. The profit margin as a percentage of revenue is much higher at 23.2 per cent

Secondly, sales of dough and ingredients is by far the biggest source of revenue and profits. It accounted for more than three-quarters of total revenue in 2017 and is extremely profitable with a profit margin of close to 30 per cent.

Thirdly, Domino's is a relatively low fixed-cost business. Net overheads and depreciation are just under 7 per cent of revenues. Most of its costs – the cost of ingredients – are variable and dependent on the level of pizza sales by its franchisees. This means that there is not a huge amount of apparent operational gearing in the business where changes in revenues can lead to much bigger changes in profits.

This may be just a coincidence, but the net royalty income – franchise royalties received less the franchise fee paid to DP Inc – pretty much covers Domino's net overhead and depreciation costs. This means that the supply chain margin or profit is not far off the total amount of operating profit for the business as a whole.

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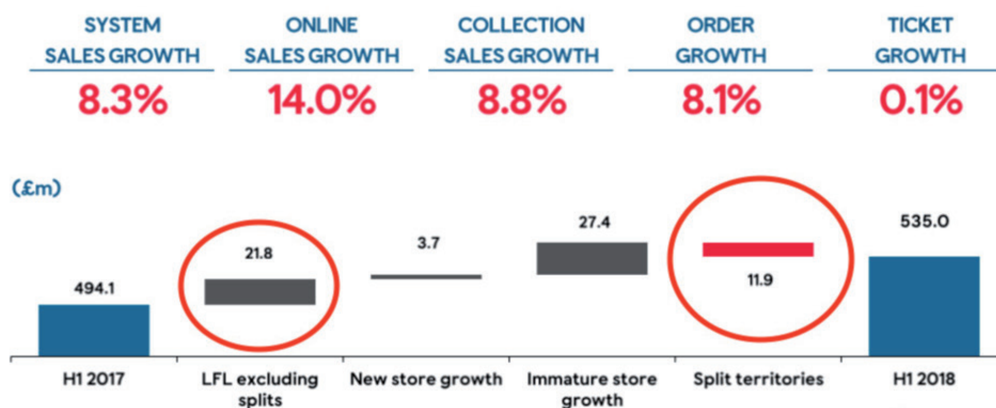
| £m | TTM | H1 18 | 2017 | H2 17 | H1 17 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|---|---|---|---|
| Franchise royalties | 61.7 | 31.1 | 59.4 | 30.6 | 28.7 | 54.4 | 47.6 | 41.2 | 35.8 |
| Royalty paid to DP Inc | -30.3 | -15.3 | -29.1 | -15.0 | -14.1 | -26.7 | -23.4 | -20.2 | -17.6 |
| Net royalty income | 31.4 | 15.8 | 30.2 | 15.6 | 14.6 | 27.7 | 24.2 | 20.9 | 18.2 |
| Net overheads & depreciation | 28.4 | 15.2 | 27.6 | 13.2 | 14.4 | 26.5 | 22.7 | 18.9 | 17.8 |
| Difference | 3.0 | 0.6 | 2.6 | 2.4 | 0.2 | 1.2 | 1.5 | 2.0 | 0.4 |
| Supply chain margin | 90.0 | 45.5 | 87.6 | 44.5 | 43.1 | 83.3 | 71.3 | 60.8 | 54.6 |
| Total UK & ROI operating profit | 96.9 | 48.2 | 93.2 | 48.7 | 44.5 | 86.6 | 74.5 | 63.8 | 55.6 |
| Supply chain as % of op profit | 92.9% | 94.4% | 94.0% | 91.4% | 96.8% | 96.2% | 95.7% | 95.2% | 98.2% |

Source; Domino's Pizza & Investors Chronicle

Whilst overall sales are still growing in the UK, I do remain concerned that the splitting strategy could be hurting Domino's and its franchisees. A slide from its half-year results presentation back in August showed that the effect of splits offset more than half of the reported like-for-like sales growth in the UK.



Source: Domino's Pizza

At its full-year results presentation in February, Domino's gave some details on the effect of splits on donor stores. Donor stores affected by splits in 2014 have performed satisfactorily but those in 2015, and particularly 2016, have fared less well. An 11 per cent fall in average weekly sales from 2016 will have had a big impact on franchisee store profits.

| Split in 2014 (£) | 2013 | 2017 | % change |
|---|---|---|---|
| Donor stores | 32836 | 34484 | 5.02% |
| New stores | 0 | 16070 | – |
| Total sales | 32836 | 50554 | 53.96% |
| **Split in 2015 (£)** | **2014** | **2017** | **% change** |
| Donor stores | 37956 | 37666 | -0.76% |
| New stores | 0 | 16354 | – |
| Total sales | 37956 | 54020 | 42.32% |
| **Split in 2016 (£)** | **2015** | **2017** | **% change** |
| Donor stores | 36076 | 31951 | -11.43% |
| New stores | 0 | 14839 | – |
| Total sales | 36076 | 46790 | 29.70% |

Source: Domino's Pizza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LFL sales growth – excluding splits – is also slowing quite rapidly from 7 per cent in the first quarter of 2018 to just 2.2 per cent during the third quarter. Overseas stores are also not contributing any profits in aggregate yet.

Domino's Pizza Group PLC (DOM)

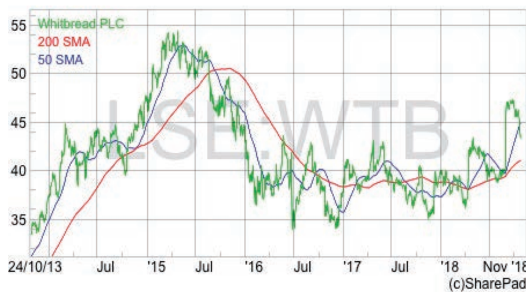
FORECASTS £ millions unless stated

| Year | 2018 | | 2019 | | 2020 | |
|---|---|---|---|---|---|---|
| Turnover | 556.1 | +23.5% | 607.7 | +9.3% | 656.5 | +8.0% |
| EBITDA | 115.0 | +25.4% | 126.7 | +10.2% | 137.7 | +8.7% |
| EBIT | 98.7 | +27.7% | 109.1 | +10.4% | 119.6 | +9.7% |
| Pre-tax profit | 96.6 | +28.1% | 106.9 | +10.6% | 117.7 | +10.2% |
| Post-tax profit | 78.3 | +24.3% | 85.7 | +9.4% | 91.9 | +7.2% |
| EPS (p) | 16.3 | +29.4% | 18.1 | +11.0% | 19.9 | +9.9% |
| Dividend (p) | 9.5 | +5.6% | 10.5 | +10.5% | 11.5 | +9.5% |
| CAPEX | 31.7 | -27.0% | 32.6 | +2.9% | 32.9 | +0.8% |
| Free cash flow | 71.6 | +42.7% | 85.0 | +18.7% | 94.3 | +10.9% |
| Net borrowing | 194.9 | +105.6% | 157.4 | -19.2% | 122.9 | -21.9% |

Source: SharePad

As a result, profit forecasts for 2018 have come down during the year. I think there is a risk that profit forecasts for 2019 are still too high given the slowing momentum in the core UK business.

That said, Domino's shares have been savagely derated this year. They were trading on a one-year forecast rolling PE of 19.5 times back in March but this has now fallen to just 14.5 times, at the current share price of 259p. A lot of caution seems to be priced in, but if forecasts are revised down for 2019 then the risk is that the shares may fall further from here.




**Whitbread**

Ownership of two very strong brands – Costa Coffee and Premier Inn hotels – has been the basis of **Whitbread's (WTB)** attraction to investors. Now that Costa is in the process of being sold, the company's fortunes rest with its budget hotel chain.

I've long thought that Premier Inn might be a target for another big hotel chain such as **Intercontinental Hotels (IHG)** or Accor. Its substantial ownership of freehold property assets might also attract the interest of financial buyers.

With Costa no longer included within the headline results, this week's half-year figures are a decent opportunity to weigh up Premier Inn on a standalone basis. In short, I would say that the company is doing alright but no more than that.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*Premier Inn UK estate metrics*

| | H1 FY19 | H1 FY18 | *Change* |
|---|---|---|---|
| # hotels | 795 | 771 | *3.1%* |
| # rooms | 74,070 | 70,120 | *5.6%* |
| Direct booking | 97% | 95% | *200bps* |
| Occupancy | 80.1% | 81.8% | *(170)bps* |
| Average room rate† | £66.16 | £65.40 | *1.2%* |
| Revenue per available room† | £52.97 | £53.46 | *(0.9)%* |
| Total accommodation sales growth | 4.8% | 8.5% | |
| Like-for-like† accommodation sales growth* | 0.2% | 4.0% | |
| Like-for-like food & beverage sales growth* | (2.6)% | 0.8% | |
| Return on capital (before corporate costs) | 13.0% | 13.4% | |

** Like-for-like sales growth for H1 FY18 reflects refined definition*

Source: Whitbread

Whitbread continues to roll out more rooms and hotels in the UK, but it is operating in a tough and competitive market. Occupancy rates remain good at just over 80 per cent – although slightly lower than a year ago – and average room rates have nudged up a little. The key measure of revenue per available room (RevPar) fell slightly.

The company has been adding a lot of rooms into the London market – 4,400 over the past three years – which is facilitating growth in this key market. That said, I do have some concerns about the company's strategy and whether it can maintain its current rates of profitability as ROCE has fallen slightly.

Growth is going to come from adding new rooms, but whether REVPAR can increase remains to be seen. The company thinks it can get to 100,000 rooms eventually and still seems to have scope to open hotels where it is not currently located – 37 per cent of its new space will be directed to these areas.

I've stayed in a few Premier Inns and think the consumer experience is good and represents good value for money. I am slightly perplexed at the company's decision to target the cheaper end of the market with smaller, simpler rooms and lower prices. It either thinks that it can take market share in this area or feels that it has to compete against others. It says it believes it can make the same returns on capital as its existing formats – time will tell.

Germany has been seen as an opportunity to replicate the success of Premier Inn in a bigger and more fragmented market, but Whitbread is making slow progress here in my opinion, with only one hotel open at the moment.

| *Premier Inn Germany network* | Organic | To be acquired | Total |
|---|---|---|---|
| Open and trading | 1 hotel *(210 rooms)* | 13 hotels *(2,140 rooms)* | **14 hotels *(2,350 rooms)*** |
| Committed pipeline | 13 hotels *(2,723 rooms)* | 6 hotels *(970 rooms)* | **19 hotels (3,693 rooms)** |
| **Total** | **14 hotels *(2,933 rooms)*** | **19 hotels *(3,110 rooms)*** | **33 hotels *(6,043 rooms)*** |

Source: Whitbread


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*"It seems that Premier Inn is not expected to deliver much profit growth in the short term due to subdued customer demand. A decent chunk of any growth is likely to come from cost-cutting"*

Even with an existing pipeline and an acquisition it will add only 6,000 rooms in Germany over the next few years. This will bring additional profits, but whether it will make the same returns on investment as in the UK remains to be seen.

Either way, it seems that Premier Inn is not expected to deliver much profit growth in the short term due to subdued customer demand. A decent chunk of any growth is likely to come from cost-cutting, according to the company's pretty downbeat outlook statement: "Given the recent economic and political environment, along with inflationary pressures in the consumer sector, there is a degree of caution on demand. The combination of our commitment to the investment programme and the current UK consumer environment naturally means our near-term profit growth may be lower than in previous years. However, Whitbread is confident that the ongoing efficiency programme can continue to offset a significant proportion of inflation over the short to medium term.

Ongoing disciplined allocation of capital and focus on executing Whitbread's plans will continue to win market share from the declining independent hotel sector in the UK and Germany, which will deliver sustainable growth in earnings and dividends and a strong return on capital over the long-term."

Despite this, I think Whitbread's Premier Inn assets are not being valued very highly based on its current profits.

| Whitbread | Value (£m) |
|---|---|
| Market capitalisation at 4354p | 7,994 |
| Add net debt and pension deficit | 1,039 |
| Enterprise value (EV) | 9,033 |
| Take away Costa proceeds net of tax | (3,800) |
| Implied EV of Premier Inn | 5,233 |
| Trailing 12-month (TTM) operating profit | 472.4 |
| **Implied EV/Operating profit** | **11.1 times** |
| Implied market cap of Premier Inn (current mkt cap less Costa proceeds) | 4,144 |
| TTM post-tax profit | 353.8 |
| **Implied PE** | **11.7 times** |

Source: Company report and Investors Chronicle

According to my calculations, Premier Inn is trading on 11.7 times its TTM post-tax profits, which suggests its subdued outlook may well be priced into the shares. This valuation may be low enough to flush out a bidder for the company in my opinion.

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**Stobart Group**

For me, the only significant assets that should be of interest to investors or potential investors in **Stobart Group (STOB)** are its ownership of Southend Airport and 12.5 per cent stake in **Eddie Stobart Logistics (ESL)**. The company has a messy history and is still involved in a dispute with its former chief executive. There was a bid for airline Flybe in March, although its failure now looks to have been a stroke of good fortune.

This is a company that looks suitable only for the most committed of investors who are prepared to do a lot of digging and number-crunching. The half-year results statement for the six months to the end of August is frankly a mess. The word 'Ebitda' (earnings before interest, tax, depreciation and amortization) is plastered all over it, which given its dodgy status as a measure of profit – particularly for an asset intensive business with significant depreciation expenses and replacement capex requirements – is a big red flag and enough for many investors to stop reading.

**12 Cash generated from operations**

| | Six months ended 31 August 2018 Unaudited £'000 | Six months ended 31 August 2017 Unaudited £'000 | Year ended 28 February 2018 Audited £'000 |
|---|---|---|---|
| **(Loss)/profit before tax** | **(18,816)** | **111,587** | **100,622** |
| ***Adjustments to reconcile profit before tax to net cash flows:*** | | | |
| Gain in value of investment properties | - | (319) | (939) |
| Realised profit on sale of property, plant and equipment and investment properties | (443) | (192) | (136) |
| Share of post-tax profits of associates and joint ventures accounted for using the equity method | 588 | (474) | (474) |
| Gain on conversion of loan | (1,095) | - | - |
| Loss/(gain)/(profit) on disposal of assets held for sale | 600 | (400) | (3,942) |
| Profit on disposal of associate | - | (123,870) | (123,892) |
| Profit on sale and leaseback | (710) | - | (4,064) |
| Profit on sale of property inventories | - | - | (540) |
| Release of deferred profit on sale and leaseback | (204) | (239) | (404) |
| Gain on redelivery of aircraft | (1,676) | - | - |
| Depreciation of property, plant and equipment | 10,931 | 6,540 | 15,332 |
| Finance income | (118) | (979) | (1,701) |
| Finance cost | 1,698 | 2,204 | 3,411 |
| Release of grant income | (4,867) | (359) | (890) |
| Release of deferred premiums | (1,308) | (1,142) | (2,346) |
| Amortisation of intangibles | 1,969 | 1,969 | 3,938 |
| Share option charge | 674 | 1,093 | 1,678 |
| Recycling of other comprehensive income amounts on disposal of associate | - | - | (3,006) |
| Foreign exchange retranslation | (1,292) | (1,789) | 30 |
| (Gain)/loss on swaps mark to market valuation | (3,579) | 659 | (971) |
| Retirement benefits and other provisions | 4,879 | (267) | (1,398) |
| ***Working capital adjustments:*** | | | |
| Decrease/(increase) in inventories | 406 | (1,004) | (1,789) |
| Decrease/(increase) in trade and other receivables | 1,618 | (3,477) | (9,867) |
| (Decrease)/increase in trade and other payables | (7,398) | 3,453 | 22,013 |
| **Cash used in continuing operations** | **(18,143)** | **(7,006)** | **(9,335)** |

Source: Stobart Group


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*"Passenger numbers during the first half of the year increased by 37 per cent to 838,742 and are expected to reach 2.5m in 2019"*

The company says it made an underlying operating profit of £9.6m during the period. Yet, it failed again to generate any operating cash flow with an outflow of £18m. A look at the calculation of operating cash flows shows a number of adjustments.

Some such as a gain on delivery of aircraft and a release of grant income – both non-cash additions profits – don't look as if they were included in non-underlying items, but I could be wrong.

The reason for the big loss was the loss incurred running franchise operations for Flybe out of Southend Airport, which was £18m during the period. This has been used as a way – a very expensive way – to highlight the viability of Southend Airport to other commercial airlines and it seems to have paid off.

Ryanair will base three aircrafts at the airport from summer 2019, which will bring in 1m passengers a year. EasyJet has also added a fourth aircraft. Passenger numbers during the first half of the year increased by 37 per cent to 838,742 and are expected to reach 2.5m in 2019.

The longer-term aim is to get to 5m passengers by 2022, with operational gearing and new retail concessions taking Ebitda per passenger to £10, from £3.26 currently.

This looks to be quite an ambitious target, but having used Southend Airport this year, I think it is a very attractive proposition for passengers and airlines, particularly as nearby Stansted becomes more and more congested. If Southend could be generating £50m of Ebitda by 2022 then its value would have significantly increased.

Whether this is enough to justify the current market capitalisation of £772m, at a share price of 214p, I am not sure. The stake in Eddie Stobart Logistics is currently worth just over £50m, with the company saying that its other investment and infrastructure assets have a balance sheet value of £167m. The biomass business is worth something, but has had problems with power station customers and the utilisation of its plant assets. Rail contracting and ground handling at airports are low-margin businesses that will struggle to create much value, in my view.

The company desperately needs to start generating some positive free cash flow. Its dividend – currently offering a yield of 8.3 per cent on the current share price – is being paid from asset disposals which cannot last.

The shares are largely an all-in wager on the potential future value of Southend Airport. A reasonable uplift looks to be already priced in. The messy accounts and poor cash flow would put me off.

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