18 September 2018

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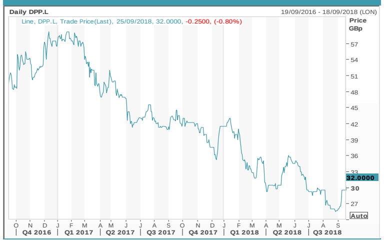
CORPORATE

Consumer & Leisure



Source: Eikon Thomson Reuters

Market data

EPIC/TKR	DPP.L
Price (p)	29
12m High (p)	45.2
12m Low (p)	24.5
Shares (m)	153
Mkt Cap (£m)	44
EV (£m)	42
Free Float*	66%
Market	AIM

**As defined by AIM Rule 26*

Description

DP Poland (DPP) has the master franchise for Domino's Pizza in Poland. It has 60 stores, of which 36 are corporately owned. It is rolling out steadily on the back of very strong revenue performance.

Company information

CEO	Peter Shaw
CFO	Maciej Jania
Chairman	Nicholas Donaldson

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www.dppoland.com

Key shareholders

Directors	5.2%
Cannacord Genuity	14%
Pageant Holdings	10%
Fidelity	10%
Octopus Investments	5%

Diary

Jan'19	Trading update
Mar'19	Final results
May'19	AGM

Analysts

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DP POLAND

Fully proven model rolls out

DP Poland (DPP) has proved that the Domino's formula works as well in Poland as it does elsewhere in the world; its mature stores are substantially profitable. With 60 stores now open in Poland but only seven mature corporately owned stores, the strength of the operation does not show up in the group profit figures. The remarkable thing about the Domino's franchise is the seemingly endless growth in same-store sales. DPP has laid the foundations of a very substantial business but, so far, there is little showing above the surface. We believe it will – in time.

- **Strategy:** DPP has spent the first few years of its existence proving the Domino's Pizza model in Poland and honing its operations. With the new commissary up and running, it has scope to double the number of operations over the next few years. As the stores mature, the success should show up in reported profits.
- **Competitive market:** DPP has neither the pizza market nor the food delivery market to itself in Poland. Both are established, but current evidence shows that the Domino's formula of focusing on high-quality pizza, delivered swiftly, is as hard to beat in Poland as it is in the rest of the world.
- **Valuation:** We are not expecting reported profits for the next few years, so we have looked at valuing DPP on a per-store basis. We value stores of different maturity separately and also look at the value of future stores. We derive a central value of around £80m, or 52p per share.
- **Risks:** In the short term, DPP faces cost pressures, especially on labour, but so do its competitors. Finding franchisees and finance for them is a hurdle. Longer term, we see general competitive behaviour as the biggest threat to our forecasts. There is also some country political risk.
- **Investment summary:** The story for DPP is quite simple: it has a powerful retail consumer franchise in a fast-developing economy. The share price has reflected the ups and downs of any startup business that would typically be sheltered from public scrutiny. DPP seems to have it all running smoothly now, and we believe the profits will follow as the existing stores mature.

Financial summary and valuation

Year-end Dec (£000)	2016	2017	2018E	2019E	2020E
Revenue	7.557	10.378	13.853	18.433	23.592
Store EBITDA	1.526	0.715	0.866	1.836	2.767
Group EBITDA	-1.580	-1.785	-1.700	-0.400	0.450
EBIT	-2.546	-2.703	-2.776	-1.516	-0.716
Finance costs	0.053	0.068	0.012	-0.009	-0.023
PBT	-2.493	-2.635	-2.765	-1.525	-0.739
PAT	-2.493	-2.635	-2.765	-1.525	-0.739
EPS (p)	-1.93	-1.85	-1.81	-1.00	-0.48
EPS adjusted (p)	-1.81	-1.85	-1.76	-0.94	-0.42
Net cash	6.0	4.1	1.4	-0.9	-2.3
Shares issued (m)	129	142	153	153	153
EV/Sales (x)	5.6	4.0	3.0	2.3	1.8

Source: Hardman & Co Research

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Executive summary

DP Poland (DPP) has been running the Domino's Pizza master franchise in Poland since 2011. It now has 60 stores open in Poland, of which 36 are corporately owned. The remainder are run by sub-franchisees. The model is well tested, and the mature stores are now substantially profitable. The success, though, is disguised by the combination of loss-making stores in their first year of opening and the central costs built up to support a network of 150 stores. As the ratio of mature to new stores shifts in favour of the former, and the store rollout continues, so the group will begin to report profits.

Fertile territory

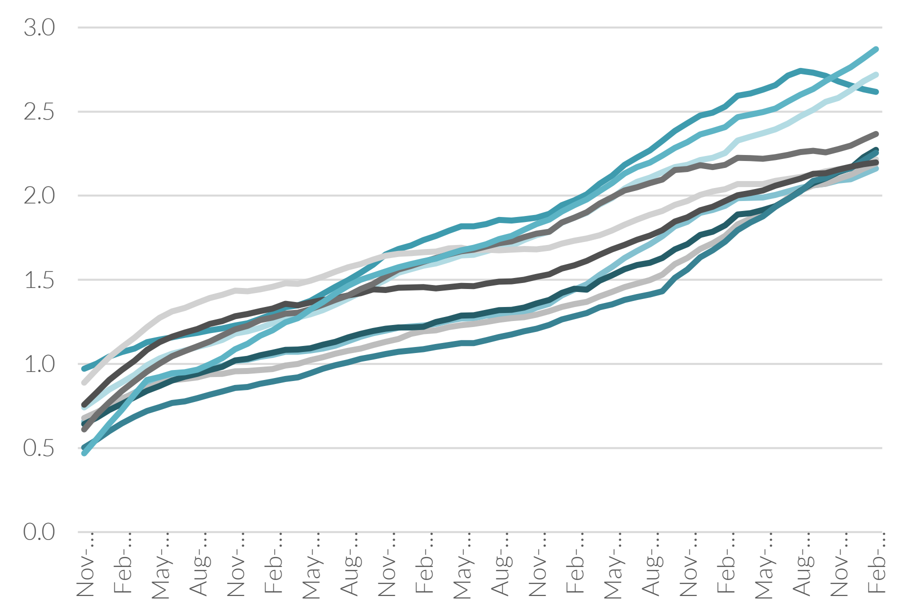
Poland is a dynamic economy. GDP growth of 4.5% this year and more than 3.5% next year is beginning to feed into price and wage inflation, which bodes well for future pizza sales. Consumption of takeaways and delivered meals has been growing in double digits and is forecast to continue to grow at over 7% p.a. for the foreseeable future.

Poland is also digitally advanced, with internet penetration at 76% and a remarkable 131 mobile phones per 100 population. This leads to much more efficient order intake in DPP's stores, where three quarters of delivery orders are now taken online – improving value per order and reducing labour costs.

Domino's dominance

The true strength of the Domino's Pizza model is its ability to generate sustainable same-store sales growth year after year. The brand has been around for decades, and is now present all over the globe and, yet, for the past seven years, US stores have grown at an annual compound rate of 7% and international stores at 6%. The international business has grown consistently for 21 years, averaging 5.7%.

DPP – first 10 stores – rolling 12 month revenues (PLNm)



Source: DPP

DPP has demonstrated that the brand is no less successful in Poland. Every quarter since opening, DPP has been able to report double-digit same-store sales growth. The chart above shows the revenue (rolling 12 months) of its first 10 stores. What is remarkable is the consistency of the growth over five years – at an average rate of 27% p.a. There is every reason to expect the growth to continue, albeit not at quite the same rate, as the Domino's brand becomes better known and as the delivery market grows in Poland with wealth and familiarity.

Mature store profitability

In their first year, stores typically make a small loss to add to the pre-opening expenses. As DPP opens more stores, their early losses detract from the more mature stores' profitability. DPP has also invested in infrastructure to support around 150 stores, a total we would not expect it to reach before 2024. Consequently, we are not expecting the group to report profits before 2021, but the value already created is very real. The mature stores are profitable, the sales growth of the less mature stores indicates that they will follow a similar path, and Domino's track record around the world makes it reasonable to assume there is scope for hundreds of stores in Poland.

Valuation methodology

Our valuation results in a value of £80m, or 52p per share

With no current profitability, we have valued DPP on a per-store basis. We take the average corporately owned store and carry out a discounted cash flow (DCF), assuming three stages of growth: the standard pattern for the first five years, followed by 6% growth for seven years, and then 4% in perpetuity. We use a 10% discount rate. On this basis, we calculate that a corporate store just about to open is worth £1.2m gross.

To turn this into a valuation for DPP as a whole, we value all the open stores at slightly higher rates, depending on how mature they are, and then we consider the next five years of openings – estimated to be 51 new corporate stores. From this, we subtract the capitalised value of the central costs less the profits derived from the franchised stores. Then we tax the outcome at the Polish corporate tax rate.

We arrive at a value of £80m, or 52p per share. To this, we could add a further 15p if we were to consider the value of the following five years of opening.

Our treatment of the revenue stream of the franchised stores is highly conservative, as it implicitly assumes it grows in line with the central costs. In practice, we would expect it to grow significantly faster.

Risks

The key risks we see are the impact of competition from not only the established players like Pizza Hut but also from delivery aggregators. We believe the main mitigating factor is the strength that the Domino's Pizza philosophy derives from its sole focus on the fast delivery and takeaway service of high-quality pizza. None of the competitors bring the same clarity of purpose, which is perhaps why it is successful all over the world.

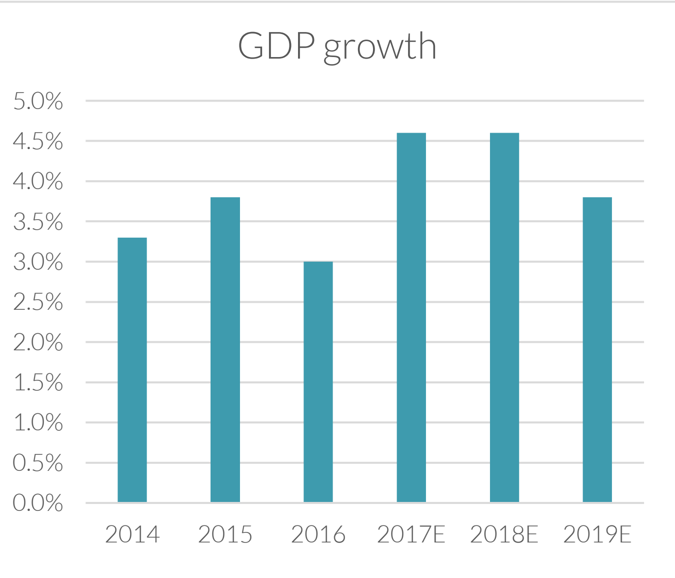
In the short term, there can be pricing pressure from ingredients (especially cheese) and from labour. DPP also has to source a stream of suitable sub-franchisees to expand that side of the business, which is not straightforward.

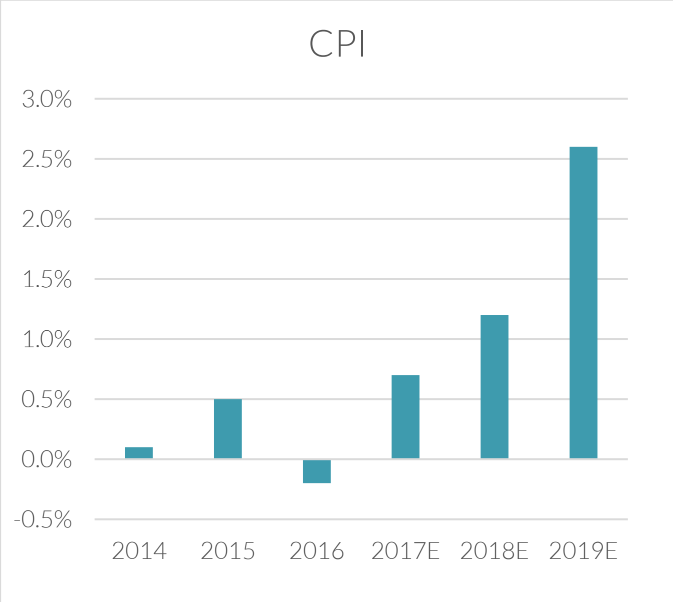
Poland

The Polish market

The last few years have seen the Polish economy powering ahead, with GDP growth of between 3% and 4.5%, unemployment falling from 7.5% in 2015 to around 4% currently and inflation, which has occasionally been negative, now picking up to around 2%.

Poland – GDP growth and CPI, 2014-19E





Source: OECD

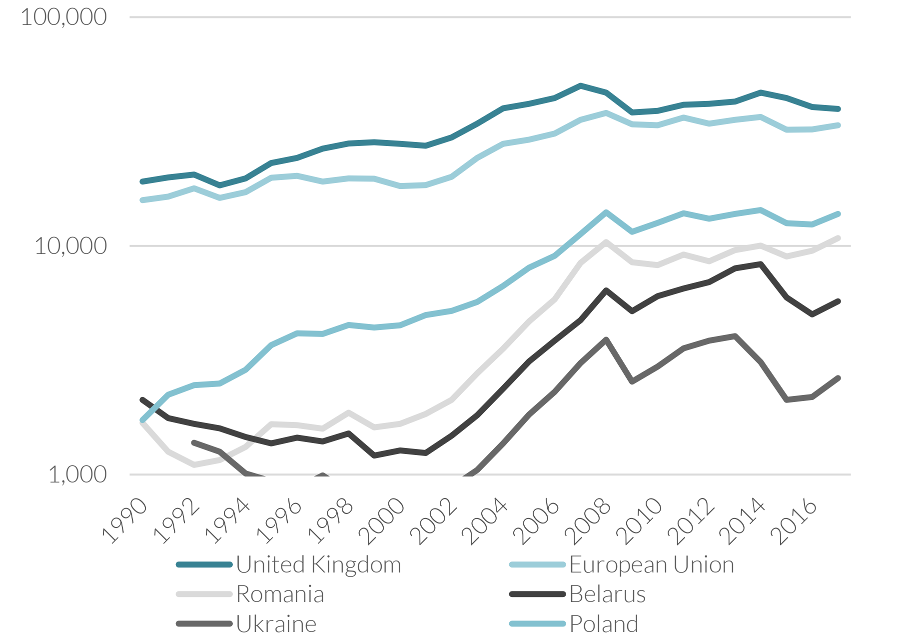
Poland's GDP per capita has more than doubled since 2004…

Poland is not a rich country compared with Western Europe. It has a GDP per capita of around $14,000, putting it on a level with Croatia and Hungary. Greece is 35% richer, Portugal 50% and Spain 100%; the EU, on average, is about 2.4x times richer, and the UK and Germany about 3x. On the other hand, Poland is substantially richer than neighbouring Belarus ($5,700) or Ukraine ($2,600) or, further south, former communist Romania ($10,800).

Furthermore, DPP's target market is the towns and cities of Poland with populations of more than 100,000, of which there are more than 40. These areas are much richer than those in the poorer surrounding countryside. Warsaw's GDP per capita is around three times the national average.

Poland joined the EU in 2004 and, since then, GDP per head has more than doubled, bolstered by substantial inward investment.

GDP per capita (US$), 1990-2017



Source: World Bank

...and wages are growing – crucial for driving demand

For DPP, the most important metric is wages. Between 2013 and 2015, wage growth hovered around 2%. Since then, it has picked up sharply, to ca.8%. This causes a headache running the stores, but it is crucial for driving future demand. There are still many Poles who cannot afford a takeaway pizza, but their numbers are shrinking and, as the populace gets richer, they will be able to afford a Domino's 'treat' more often.

Poland – employment market, 2010-19E

Source: OECD

Doing business in Poland seems relatively safe

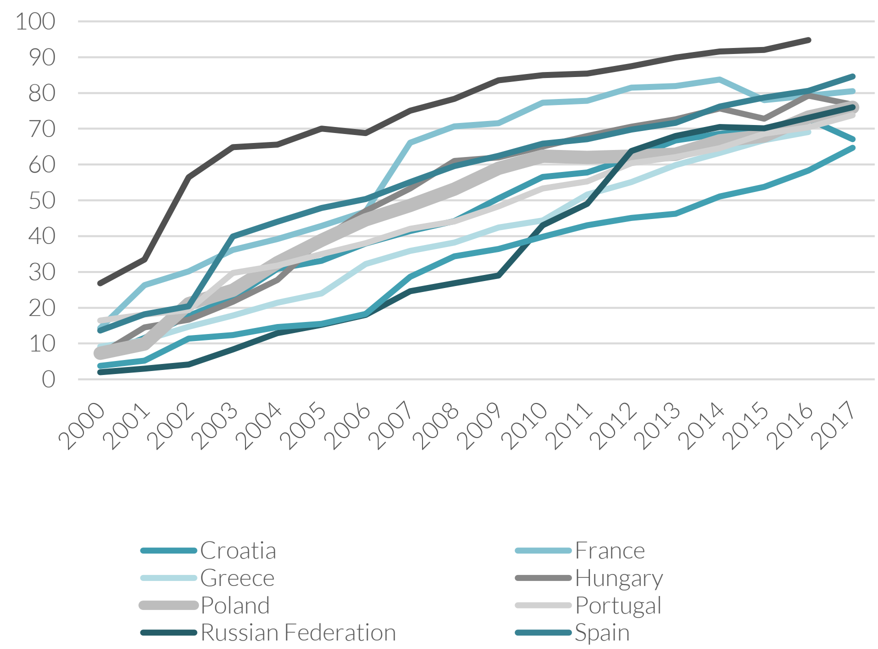
Transparency International ranks Poland 36th in its corruption Index, up from 41st in 2012, which we note is a perfectly respectable place to be: ahead of Spain (43rd), and Italy (55th) and substantially ahead of Romania (59th) and Ukraine (130th). There is, in practice, no abnormal burden to doing business in Poland.

Advanced digital economy

Like many other developing economies, Poland has been swift to adopt both the internet and mobile telephones. With internet penetration at 76%, it is right up there with most of Western Europe.

Poland has a lost generation – those who were too old to adapt after the Berlin Wall came down and are forced to survive on poor pensions. They are unlikely to be online now and unlikely ever to be a significant spending force in the future – so the internet penetration of DPP's target market is probably close to the total.

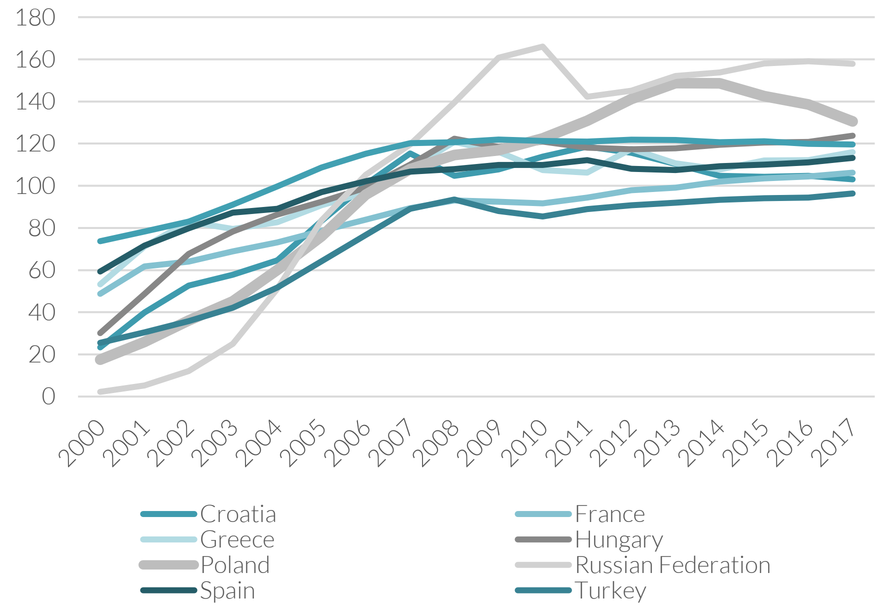
Percentage of individuals using the internet



Source: International Telecommunications Union

The same is true of mobile phones, where Poles have a remarkable 131 phones per 100 population, higher than the UK (120) or France (106). Indeed, only Austria (171), Russia (158) and Italy (141) are higher in Europe. This is important for DPP, as online ordering, which already represents the vast majority of its business, is efficient and attractive.

Mobile phone subscriptions per 100 people



Source: International Telecommunications Union

Political instability

The one macro negative currently is the political situation in Poland, where the rise of the populists, in common with other parts of Europe, is upsetting the EU, with the government's encroachment on judicial independence. We do not pretend to be political experts, but it seems to us that Poland benefits so much from being a member of the EU, both financially and in terms of national security, that it is unlikely, in practice, to stretch its relationship so far that it jeopardises either. Nevertheless, it remains a risk.

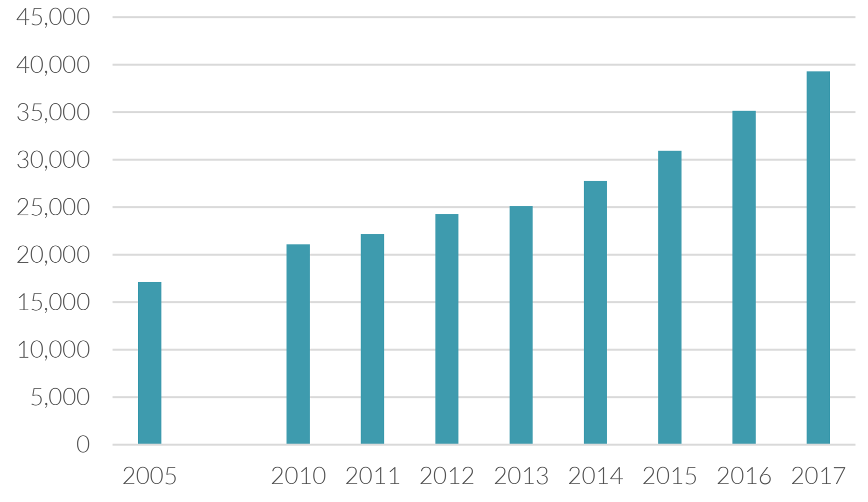
Catering sector

Expect spend in catering sector in Poland to continue to rise

Focusing on the relevant sector data, we note that retail sales in catering establishments have grown at 12% p.a. for the past four years in Poland, with growth concentrated in restaurants and food stands, and with bars shrinking.

This is unsurprising in an immature economy that is growing personal wealth swiftly. The total annual pend per head is just over PLN 1,000, or about £200. In the UK, the annual spend per head on eating out is around £1,000, and that excludes alcohol. We would expect spend on eating out (and we include takeaways and deliveries in that definition) to grow at a multiple of total economic growth. We would also expect it to be concentrated in the major towns and cities.

Retail sales in catering establishments (PLN m)



Source: Concise statistical yearbook of Poland

Established international brands

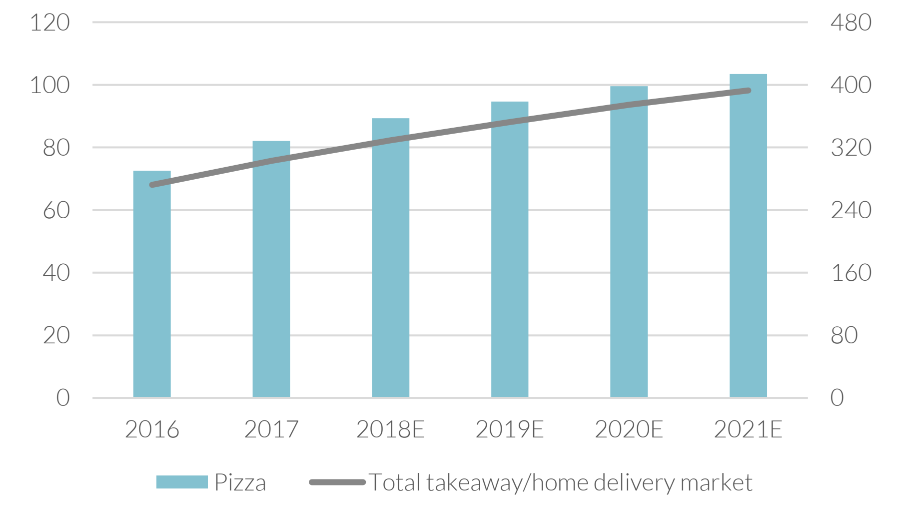
Most of the major international brands are established in Poland. McDonald's has nearly 400 outlets, and Subway and Costa both have well over 100. Amrest, a Warsaw listed company, has more than 200 KFC units, 35 Burger Kings, 47 Starbucks and more than 80 Pizza Huts.

The Pizza Hut business is spread across three different formats: the traditional restaurant "Red Top", Pizza Hut Express and Pizza Hut delivery. Only the last competes directly with DPP.

Takeaway/home delivery

Euromonitor has produced a report on the takeaway and home delivery market in Poland; it estimates that this section of the catering market grew 11% in 2017 and, within that, the pizza segment grew 13%. It forecasts, conservatively in our view, that the market and the pizza segment will grow at just over 7% between 2016 and 2021.

Sales in home delivery/takeaway category, 2016-21E (PLN m)



Source: Euromonitor

Euromonitor says that DPP was the lead player in the takeaway/home delivery sector in 2016, with a share of 4%. Since then, it has roughly doubled in size.

Conclusion

Fertile for investment and low-risk

Poland is very fertile territory for investment: the infrastructure is good and growing, the market is benefiting from strong inward investment, especially from the EU, and the economy is benefiting from Poland leapfrogging straight to new technology, such as e-commerce. The country is also part of the EU, with all the political and commercial benefits that follow from that; it is not a high-risk, emerging economy country.

Domino's Pizza

DP Inc

A phenomenal franchise

DP Inc is a US-listed global franchise business. Approximately half of its system sales are international, and half are domestic (i.e. in the USA). Internationally, it is present in 85 different countries, with over 9,000 stores. Half of all the international stores are owned by just four, very substantial, public companies, as shown in the table below.

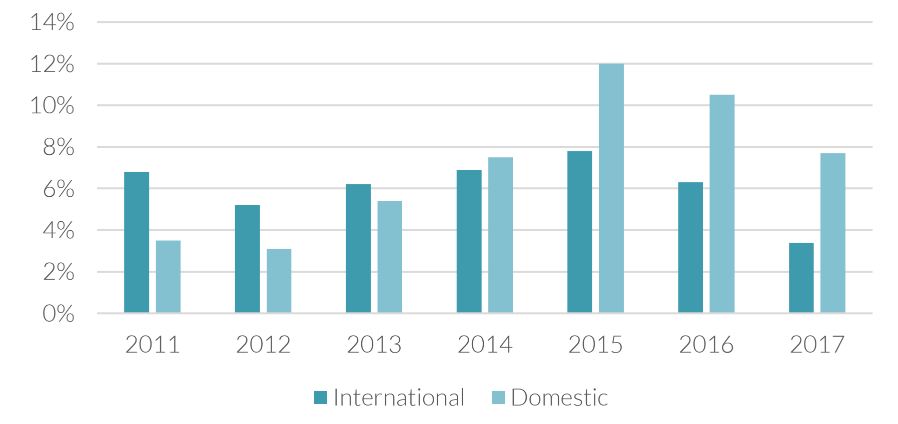
Domino's Pizza – largest franchisees

	Mkt Cap (USDbn)	Stores	Revenues (USDm)	Territories
Domino's Pizza Enterprises	3.3	2,193	943	Australia, NZ, Belgium, France, Japan, Germany
Jubilant Foodworks	2.9	1,144	498	India, Sri Lanka, Bangladesh, Nepal
Domino's Pizza Group	1.8	1,213	728	UK, Ireland, Switzerland, Lichtenstein, Luxembourg
Alsea SAB de CV	3.0	1,054	2,449	Mexico, Spain, Colombia

Source: DP Inc

What is remarkable about the Domino's system is the persistence of same-store sales growth, even in a hyper-mature market like the US. For the past seven years, the international stores have grown same-store sales at a compound rate of 6%, and the US stores have grown at 7% – this equates to 50% and 60% growth over the period, respectively.

Domino's Pizza – same-store sales growth

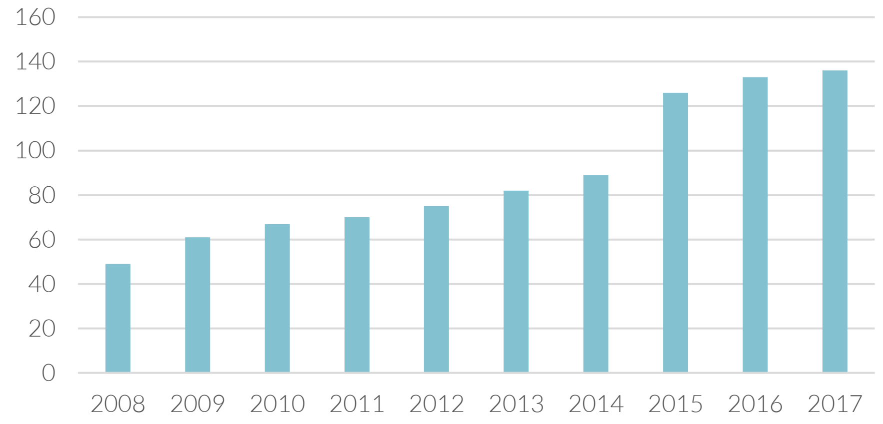


Source: DP Inc

The international business has grown consistently for 21 years, averaging 5.7% growth each year. That is a phenomenal franchise.

In the US, DP Inc has a 29% share of the pizza delivery market and, internationally, it is number one or two in each of its top 15 markets. It takes time to build up a franchise from scratch but, over time, the franchises become extremely strong, persistent cash generators. The average US store (and the vast majority are franchised rather than corporately owned) reported EBITDA of $136,000 in 2017. EBITDA has grown every year since 2008, at a compound rate of 12%.

DP Inc – average US franchise store EBITDA (USD '000)



Source: DP Inc

DP Inc, at its most recent interim results presentation, said that it expected 3%-6% same-store sales growth, both domestically and internationally, over the next three to five years. This is a business that would seem to still have plenty more to give.

DP Poland (DPP)

DPP confident that Domino's Pizza will become Poland's favourite brand

The Domino's philosophy is simple: every pizza is made to order from a fresh dough ball and high-quality ingredients. It is baked and delivered piping hot to the customer within 30 minutes of ordering.

There is a lot of pizza in Poland, but the general quality is poor and delivery is unreliable. At least one of the largest competitors uses cheese substitutes (supplemented with wheat protein and palm oil to reduce cost), cheap meats and frozen dough bases. All of this compromises taste and goodness. By comparison, DPP uses pure mozzarella, high-quality meats and fresh vegetables, and makes sure that its customers get lovingly-made, piping-hot pizza, every time.

Running a pizza delivery operation requires great organisation, passion and care. DPP ensures that its staff understand that the customers always come first. By ensuring that the quality of the product and service are delivered to Domino's Pizza's worldwide standards, DPP is confident that it will become Poland's favourite pizza brand. It has started well.

DPP opened its first store in Warsaw in 2011, having acquired the master franchise in June 2010 and having listed on AIM as a startup in July 2010. It now has 60 stores across Poland.

DPP store locations

Source: DPP

Despite new stores facing losses initially, they should become profitable far into the future

DPP's development from scratch has been in the full glare of a public listing, and it has yet to report a profit. The market has perhaps been ungenerous in its assessment of DPP's progress to date, and has arguably been too impatient. While the model is essentially a very simple one, in practice every territory has its own characteristics, and it takes time to adapt the business to have it running optimally.

If there is any drawback to the DPP model, it is that, initially, stores are loss-making, compared with, say, a restaurant or pub, which would expect to make an operating profit almost immediately (if successful). What that means, in simple terms, is that the more stores DPP opens, the higher its losses will be and the headline numbers will hide the underlying progress.

In this report, we demonstrate that, behind the new store losses, there are already some very profitable stores, which we would expect to continue to grow profitability far into the future. The existence of these stores and their familiar development path demonstrate that Domino's Pizza works in Poland and that the current management team has proven the model. The profits will flow in due course, depending on the timing of the opening programme.

Honing the model

Location …

Any new territory will pose different challenges, and Poland is no different. Getting locations right is the first thing. When Domino's is new to a country, it pays to have some high-profile locations to promote the brand. Once it is well-known, then it is more appropriate to have off-high street locations in dense population areas. Getting the store size right is also important. DPP started with larger stores and subsequently developed the S2 format in 2013 – a store format that was around a third smaller, with correspondingly lower rents. The capex required was also 30% lower.

On our visit to Poland, we went to one of the slowest-performing stores – on a retail park. There is nothing wrong with the site – in many ways it is ideal; the issue is that many of the surrounding brand-new properties have not yet been sold and lie empty. Once they are inhabited, the business will surely pick up.

…labour…

Finding the right labour is probably DPP's biggest operational issue. As Poland's economy has blossomed, unemployment has come right down. DPP finds many of its employees from among Ukrainian visitors with work permits. Labour costs have risen, though, but while this is an issue, it does has a silver lining: the richer the workforce, the higher the demand for takeaway pizzas.

…and marketing

Marketing has to be tested. What works best? Leafleting has always proved to be highly effective – usually combined with a price promotion. Initially, when there are only a few stores, the marketing has to be locally targeted. Once the whole country is covered, then it can move to nationwide campaigns. DPP did try some national TV advertising in 2018, and it had an immediate dramatic effect on orders, but this type of advertising is expensive; it will be much more cost-effective when there are rather more stores than the 50-odd in existence at the time.

Commissary

Commissary operates as the profit centre for the franchise stores

Another crucial investment is the commissary. The commissary (an American military term) is what Domino's calls its central warehouse and dough preparation centre. DPP started with some space in a lot catering facility in Warsaw before building its own. The Warsaw commissary has capacity to service about 50 stores.

In 2015, it opened a new facility in Łódź, which is very well sited on the Polish motorway network to serve the whole of Poland. It has capacity for around 100 stores. It is totally modern and is a very impressive facility. In due course, DPP will have to build more commissary capacity, but it should have enough for the next five years at least.

The commissary operates as the profit centre for the franchise stores, as well as supplying the corporately owned stores. It sells all the supplies to the franchisees, from dough to toppings to the cardboard boxes in which the pizza is delivered. All the charges made to franchisees for marketing, advertising and ordering software etc. are put through the commissary revenue line.

The commissary also acts as a price buffer for the franchisees. When cheese prices are rising fast, the commissary will not pass on the whole rise, mindful of the franchisees' profitability. Equally, when prices fall, the commissary will recoup the costs of the implicit subsidy.

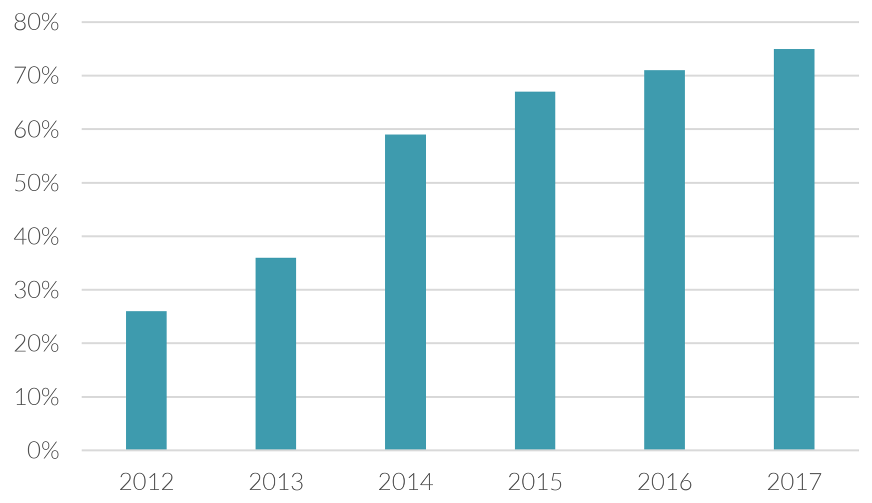
Recognition of operational excellence

DPP has won Gold Frannies two years in succession from DP International, its franchisor. Gold Frannies are awarded each year to a small proportion of Domino's franchisees in recognition of operational excellence, product quality, brand stewardship and growth. From an investor's point of view, these awards are simply confirmation that the company is well managed and is extracting the proven benefits of the Domino's Pizza brand.

Online ordering a substantial benefit

The Poles have taken to online ordering. Currently, 77% of orders are taken online, which is a substantial benefit. Online orders remove the risk of misunderstanding over the telephone and are easier to manage in the store when it is busy – you do not need dedicated staff answering the telephone, so it is cheaper too. These orders also tend to generate slightly higher order value, as customers can be more easily targeted with offers or promotions.

Percentage of delivery sales ordered online in Poland, 2012-17



Source: DPP

It will not be long before all ordering is done online. The added benefit of online customers is that marketing can be directed more efficiently to existing and lapsed customers. It is, of course, important that the website and the apps are kept constantly up-to-date – another service that DPP provides to its franchisees, as well as it owns stores.

Competition

Competitor activity can hurt, but much of the competition is not as focused as DPP

Pizza was well established in Poland before DPP arrived. The largest chain has around 180 stores, and there are several other substantial operators, as well as plenty of single-outlet operators. Most of them operate a hybrid restaurant/takeaway business. DPP tends to focus almost exclusively on delivery, with stores having little more than a couple of tables if callers want to eat their pizzas there or come in and take them away. We believe the focus on delivery is crucial to DPP's long-term success. It is the combination of quality and assured speed in delivery that makes the Domino's model so successful over such a long timeframe. Its competitors' distractions only help Domino's in its dominance.

Poland pizza chains

Chain	Stores	Notes
Telepizza	107	Acquired by Amrest
Pizza Hut	117	Only a few are delivery
Gusto Dominium	70	National
DPP	60	
Papa Johns	5	Warsaw Only
DA Grasso	178	Started in 1996

Source: Hardman & Co Research

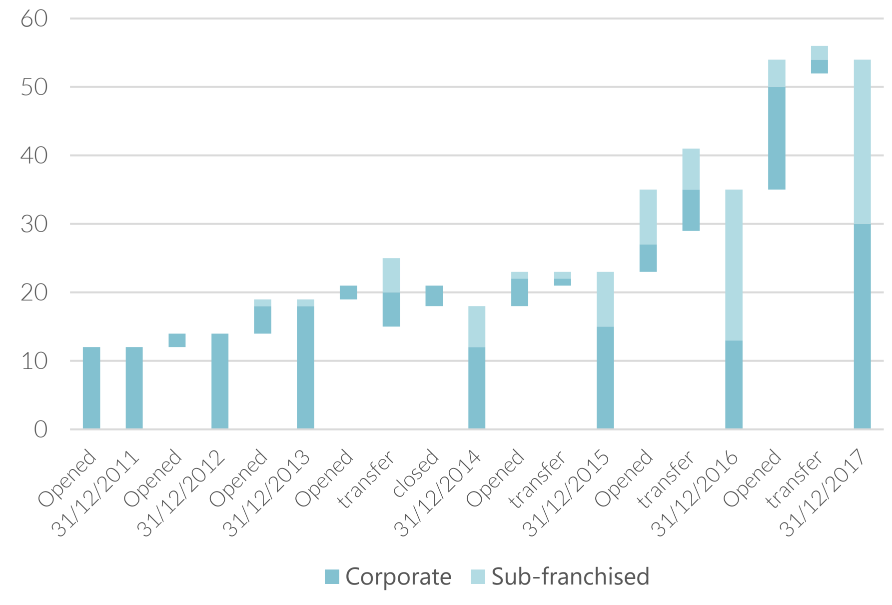
The new competition on the block is not from other pizza operators but from the delivery aggregators like Uber Eats, Just Eat and Delivery Hero. It would be foolish to dismiss this threat – they are clearly competition – but they too are unfocused. The strength of the Domino's focused model – quality + reliability – will, we believe, win out. With a well-established customer base and 60 stores nationwide, it is now a robust proposition. Of course, competitor activity can still hurt but it tends to have a lower impact and is short-lived.

We view as helpful the recent acquisition of Telepizza by Amrest – a large European-wide restaurant operator listed in Warsaw. Amrest is expected to close some of the 100-odd Telepizza stores and convert the rest to Pizza Hut. It is unlikely, in our view, that they will all be Pizza Hut delivery outlets. Telepizza operated at the discount end of the market and, while it did not compete on quality, dragging down the price point is never helpful.

Store openings

The first store opened in February 2011 and there were 11 more openings before the end of the year. All the stores were owned and run by DPP. In 2012, just two more corporate stores opened, as the management tweaked the business. In 2013, the first sub-franchisee opened.

DPP store numbers and opening schedule



Source: DPP

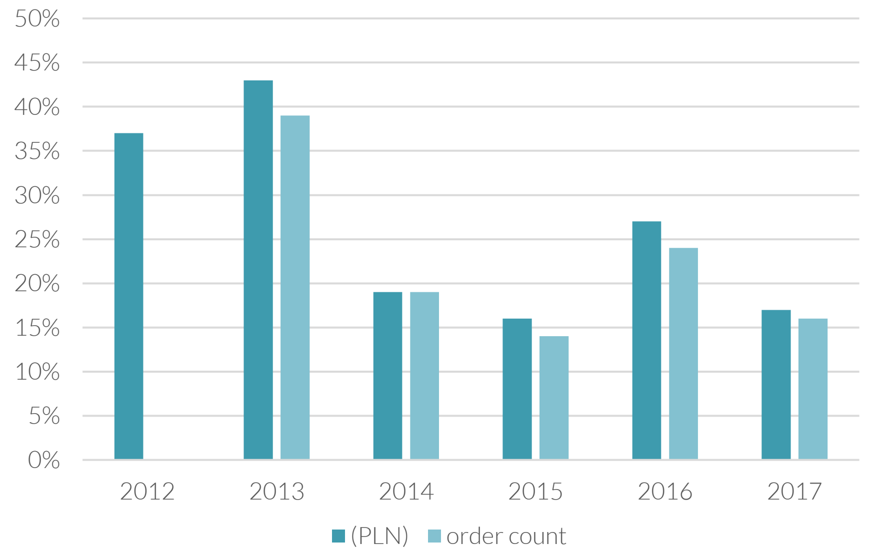
Every quarter since opening the first store, DPP has registered double-digit same-store sales growth

In 2013, three underperforming stores were closed and five corporate stores were transferred to sub-franchisees. DPP also developed a new store format, which was about 33% smaller and saved significantly on both fit-out costs and rents. This format is now the standard used for opening all new stores. The typical cost of opening a new store is around PLN 700k (about £145k).

Store openings accelerated in 2016 and 2017, with franchisees dominating in 2016 and corporately owned stores in 2017. DPP expects that roughly 80% of new store openings will be corporately owned in the near future, leading to a two-thirds corporate, one-third franchise mix by 2023.

The stores have performed extremely well. Every quarter since opening the first store, DPP has registered double-digit same-store sales growth. The chart below shows the annual same-store growth figures for both sales and order count.

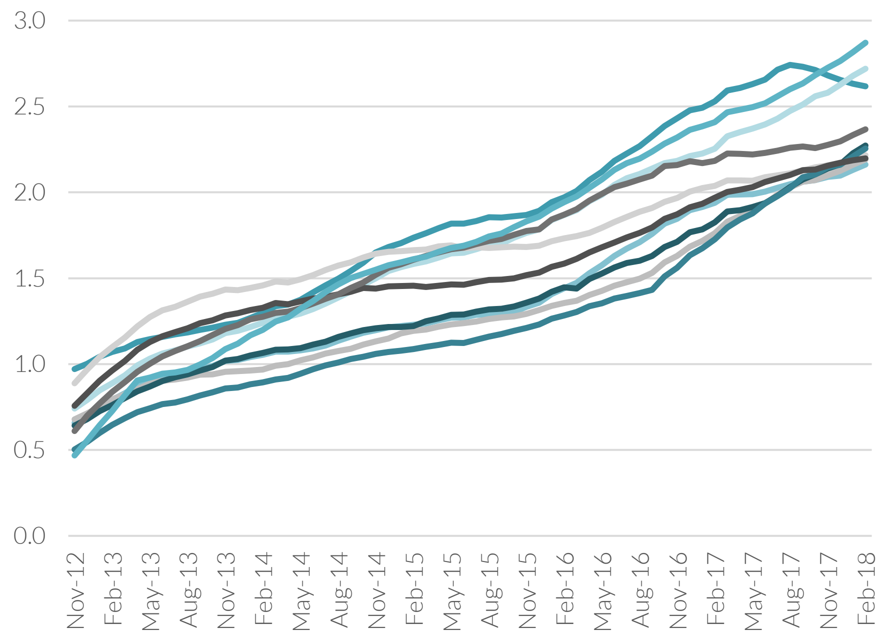
Annual same-store sales growth and order count



Source: DPP

The true strength of this growth is better shown in the following chart. It shows the rolling 12-month sales for the first 10 stores DPP opened (excluding the three closed ones). Note that two and a half million zloty is approximately £520,000.

First 10 stores – rolling 12 month revenues (PLNm)



Source: DPP

It is the consistent growth that is so noticeable. These stores have all doubled, or more than doubled, their annual revenues over four years.

The top store that turns down in the last few periods is DPP's first store, which had its territory split. Each store has a designated territory and, once the original store is full to capacity, it is time to open a new store. The territory is split, and the new store is handed some of the addresses of the old. The new store thus commences with a head start.

Splits are a crucial part of the Domino's Pizza model. Domino's Pizza's whole business proposition is to deliver a high-quality pizza swiftly. By cutting down the size of the territory, delivery times can be cut and made more consistent; this makes the competitive proposition even harder to match, let alone beat. Territories can be split, and split again, as the business builds.

Corporate store profitability

When the first store opens, there is no scale and no brand recognition, and the market is unknown. Nevertheless, the first 10 stores (excluding the three that were shut) are now very profitable. The path to profitability has become easier, as the model has been honed and there are scale benefits in purchasing and distribution, and prompted awareness brand recognition is now up to 83% in Warsaw. All other things being equal, future stores will see further improvements. For now, we have a model of what a new store opening today should be able to achieve.

Typical DPP store

PLN k	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	600	1,000	1,350	1,700	2,200
Food cost	-215	-300	-400	-500	-600
Labour	-265	-360	-420	-540	-660
Royalty	-24	-40	-54	-68	-88
Other opex	-265	-265	-280	-290	-340
Total cost	-769	-965	-1,154	-1,398	-1,688
EBITDA	**-169**	**35**	**196**	**302**	**512**
Capex	-65	-65	-65	-65	-65
Cash flow	-234	-30	131	237	447

Source: Hardman & Co Research

Of course, each territory is slightly different, and each store manager is different too, but this is the profile of an average store.

We believe that one way of looking at the value in DPP is to look at the profitability of the existing stores – separated into maturity bands – and then look at the value of future stores.

If you extrapolate the typical store model out to eternity and discount the cash flows back to today, you get a pre-tax value per store of £1.2m.

Value of a typical DPP store

Value	PLN k	£k	% of value
Cost	-700	-146	-12%
Cash flow to year 7	895	186	15%
Cash flow years 8-14	1,770	369	30%
Cash flow in perpetuity post year 14	3,987	831	67%
Total	6,052	1,240	100%
Multiple of year 12 EBITDA	7.2x		

Source: Hardman & Co Research

In this model, we have used our standard discount rate of 10%. The other key variable is the growth rate. We have used 6% from year 7 to year 14 and 4% thereafter.

This model is for one shop from pre-opening. Mature stores that have already been through the build-up phase are worth more – the initial capital has already been spent and the early year(s) of lower profitability are behind them. In the table below, we show what a store is worth using our same central assumptions, depending on how mature it is from pre-opening, through to year 1, through to year 5.

Value of store depending on current maturity

	Value (PLN k)	Value (£k)	EBITDA Yr 12 (PLN k)	EBITDA Yr 12 multiple
Year 0	5.952	1,240	825	7.2
Year 1	7,563	1,576	825	9.2
Year 2	8,350	1,740	825	10.1
Year 3	9,048	1,885	825	11.0
Year 4	9,704	2,022	825	11.8
Year 5	10,206	2,126	825	12.4

Source: Hardman & Co Research
Note: we have used PLN 4.8=£1

We then apply the values for each maturity cohort to the number of stores that DPP currently operates, and we arrive at a total value for the corporate stores of £70.5m.

DPP current store value (£m)

Maturity	No. of stores	Present value per store	Total value
Year 0	5	1.2	6.2
Year 1	5	1.6	7.9
Year 2	15	1.7	26.1
Year 3	5	1.9	9.4
Year 4	3	2	6.1
Year 5	7	2.1	14.9
Total	40		70.5

Source: Hardman & Co Research

We can be reasonably confident about the scope to open lots more stores and their future average profitability. DPP has already shown that the model in Poland, the expansion model, has been proved in territories all over the world. What is difficult is getting it started, honing it and then financing it through to self-sustained profitability. Investors looking at DPP have the opportunity to buy in after much of the hard work has been done.

With the model proven in Poland and around the world, we feel that it is perfectly appropriate to look at the value that is yet to be exploited in the ownership of the master franchise for Domino's Pizza in Poland. In the table below, we look at the current store value, those out to 2023 and those out to 2028.

DPP value of current and future stores out to 2023-28 (£m)

Value	£m	Plus next 50 stores to 2028	Total
Current stores	70.5		
Future stores to 2023	48.0		
Net central costs	-23.2		
Total	95.4		
tax @ 19%	-18.1		
Net cash	2.3		
Value	79.6	23.6	103.2
per share (p)	52	15	68

Source: Hardman & Co Research

This model shows the value of the current stores (£70.5m), the value of the next 51 stores expected to open up to 2023 (£48.0m) – taking the total corporate stores to 91 – and then it subtracts what we have called "net central costs". We have derived this figure by taking the profits from the commissary and deducting both the central costs in Poland and the central PLC costs in the UK. We have then capitalised this figure at 10x.

Commissary value less central costs			
PLN k	2018	2019	2020
Commissary EBITDA	3,947	5,039	6,259
Poland central costs	-13,253	-12,771	-14,381
UK costs	-3,000	-3,000	-3,000
Net other costs	-12,306	-10,732	-11,122
Capitalised @10x			-111,216
In £m			-23.2

Source: Hardman & Co Research

We view this as a very conservative way of looking at the value. We would expect the commissary profits to rise faster than the central costs. The PLC costs should rise only slowly, as they are largely fixed in nature. The Polish central costs have a significant variable element as the business grows in size, but there is still a healthy level of operational gearing in this function.

Once the business is more developed, we would look to value the commissary separately and then capitalise just the central costs to deduct from the total.

Finally, we have deducted tax at 19% – the Polish corporate tax rate – from the total value and added back DPP's net cash to arrive at a current value of £80m, or 52p per share.

We have also calculated that 10 stores opened each year between 2024 and 2028 would add a further £24m, or 15p per share, to our estimate.

Sensitivity analysis

In the table below, we show the sensitivity to different assumptions. We have varied the discount rate (by row), and we have varied the growth assumptions (by column) for the period from year 7 to year 14 (from 3% to 10%) and the perpetuity growth rate (from 3% to 4%).

Varying values for DPP current value depending on assumptions					
Discount rate	Growth rates (years 7-14, perpetuity)				
	3%, 3%	6%, 3%	6%, 4%	8%, 4%	10%, 4%
6%	148	219	315	395	486
8%	78	115	138	173	212
10%	48	71	80	100	123
12%	31	46	51	64	79
14%	20	31	34	43	54

Source: Hardman & Co Research

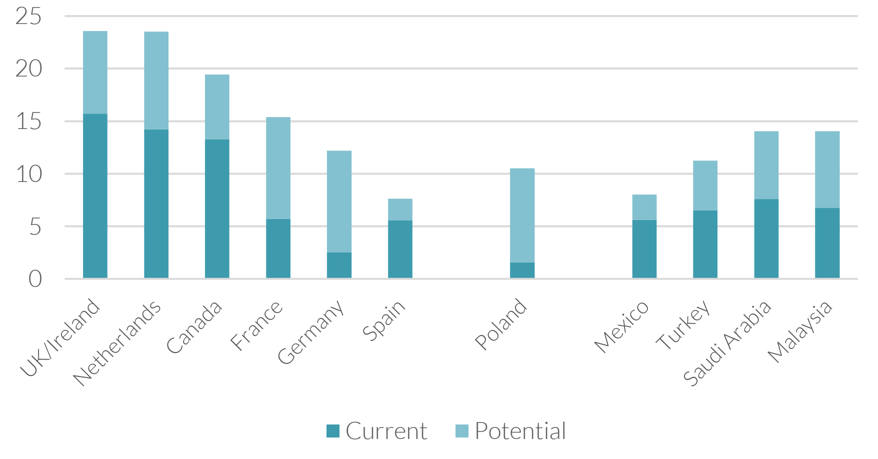
Unsurprisingly, a heavily back-end-weighted valuation is very sensitive to the discount rate. We see our usual 10% rate as perfectly appropriate to such a robust business model as DPP's.

Store density

The assumptions we have made equate to 141 corporately owned stores by 2028. At the same ratio of stores to population in other markets, there is room for at least 400 total stores in Poland, including sub-franchised stores, in our view, which would equal 10.5 stores per million of population.

Taking data from DP Inc and comparing them with each territory's population yields the following results.

DP store density per million population, current and potential



Source: DP Inc and the UN

Three developed market territories – UK/Ireland, Netherlands and Canada – already have more than 13 stores per million of population, which would equate to around 500 in Poland. DP Inc estimates that the developed markets could each have ca.50% more stores. Germany is a very underdeveloped market for Domino's Pizza, and currently has just over 200 stores. DP Inc estimates the potential at 1,000 stores or 12 per million.

In the emerging territories (on the right of the chart), these countries already have more than five stores per million, and DP Inc thinks the capacity is above 11, with the exception of Mexico, which is set at eight.

Conclusion

Any valuation that looks out five years or more from a current loss-making business will be surrounded with risks and uncertainties. What makes DPP different is that the risks are minimised by both the current significant profitability of its mature stores and the proof of the Domino's Pizza model in many other parts of the world. This is not a speculative or fashionable venture; rather it is the rollout of a tried-and-tested model that has already demonstrated its efficacy within its Polish territory.

Financials

Current profitability

In the valuation calculations above, we used a notional average store. In this section, we look at our estimates of the actual store performance, focusing on corporate stores. We have split the performance of the stores into the same cohorts by year of maturity.

As at the beginning of 2018, there were 30 corporate stores. During the year, 10 or 11 new corporate stores will have been opened – five in the first half – making a total of 40 or 41 by the end of this year. Of these, seven will have been open for more than four years, three moved from year 3 to year 4, seven moved from year 2 to year 3, and four moved from year 1 to year 2.

DPP store numbers by maturity

No. of stores	2018	2019	2020
Year 1	10	10	11
Year 2	15	12	10
Year 3	5	15	12
Year 4	3	5	15
Year 4+	7	10	15
Total	40	50	61

Source: Hardman & Co Research

As the store matures, so the revenue grows. There is a mixture of fixed costs, e.g. rent and a base level of staff, and variable costs such as food and staff numbers. For example, the busier the store, the more delivery drivers, in particular, are needed. In the first year, the revenue tends to be a bit lower, as there will typically be substantial promotions to get the store off the ground.

The other distorting factor is that DPP has some extremely successful stores in Warsaw. As more stores are opened outside Warsaw, they are likely to have lower overall sales at a comparable stage of maturity. So, over time, the typical revenue of a store five years or older is likely to come down from around PLN2.6m to PLN2.2m – which is what we assumed in the valuation calculations. This is captured in the table below, which shows our forecast for corporate store revenue and profitability over the next three years.

For each forecast year, a store moves from one year cohort to the next one, as it matures, i.e. the rising revenues in, say, "year 4" represent the growing number of four-year-old restaurants, not the cohort of restaurants that were four years-old in 2018.

Store profitability, 2018-20E (PLN k)

	2018E	2019E	2020E
Revenue			
Stores in their first year	3,250	3,250	3,275
Stores in their second year	12,000	9,720	9,720
Stores in their third year	7,260	16,950	13,560
Stores in their fourth year	3,400	9,911	22,525
Stores older than four years	17,550	20,655	30,618
Total	43,460	60,486	79,698
Variable cost			

Year 1	-1,593	-1,593	-1,605
Year 2	-5,880	-4,763	-4,763
Year 3	-3,557	-8,306	-6,644
Year 4	-1,666	-4,856	-11,037
Year 4+	-8,600	-10,121	-15,003
Total	-21,295	-29,638	-39,052
Fixed cost			
Year 1	-2,340	-2,470	-2,555
Year 2	-6,375	-4,800	-4,800
Year 3	-2,772	-6,450	-5,160
Year 4	-984	-2,376	-6,450
Year 4+	-5,538	-5,940	-8,400
Total	-18,009	-22,036	-27,365
EBITDA			
Year 1	-683	-813	-884
Year 2	-255	157	157
Year 3	931	2,195	1,756
Year 4	750	2,679	5,038
Year 4+	3,413	4,594	7,215
Total	**4,156**	**8,812**	**13,281**

Source: Hardman & Co Research

The key message from this table is that DPP already has a significant cohort of profitable stores, and this is growing as the maturity profile ages. First-year stores contribute a small loss and second-year stores a trivial profit at the store level. By the third year, they are making a reasonable profit, and this grows quickly as the operational gearing kicks in.

Seven mature stores will be making three-quarters of the store EBITDA in 2018. By 2020, there will be 14 mature stores.

Clearly, as DPP opens more stores, each of the new (unprofitable) stores detracts from the profitability of the whole. Equally clearly, as the new stores diminish as a percentage of the total number of stores, that impact is diluted.

Commissary profitability

All the revenues from the sub-franchisees come through the commissary. These include the royalty payments, advertising fees, software fees for the online ordering system, utility bills, lease payments and all the consumables, including food and drink. We believe these payments amount to around 59% of sub-franchisee store revenues.

For our model of the sub-franchisee stores, we have assumed revenue per store follows the same maturity model as the corporate stores. In some territories, sub-franchised stores outperform the corporate stores. There has been no evidence of that happening in Poland so far.

Commissary revenues and gross profit, 2018-20E (PLN k)

	2018E	2019E	2020E
Franchisee revenue	39,038	47,448	56,852
Commissary revenue	23,032	27,994	33,543
Fixed costs	-1,120	-1,120	-1,120
Variable costs	-17,965	-21,836	-26,163
Total costs	-19,085	-22,956	-27,283
Commissary gross profit	3,947	5,039	6,259
Margin	17%	18%	19%

Source: Hardman & Co Research

Over time, the commissary will become a very significant contributor to group profit, in our view.

Other model assumptions

We have assumed very steady margins – i.e. we are not anticipating any unusual commodity price movements or any out of the ordinary competitive activity, and we assume stores grow their revenues as they mature – we do not assume any underlying inflationary growth.

We are assuming central costs in Poland are static in 2019 over 2018 – reflecting some early investment in expansion that DPP has already put in place – before resuming an upward path in 2020.

We have assumed a constant exchange rate of PLN 4.8 = £1.

Other costs include the PLC costs, which are a mixture of cash and non-cash share-based compensation.

DPP is benefiting from some VAT repayments in 2018, which will, we estimate, leave it with a PLN1m net working capital inflow. Otherwise, working capital is assumed to be static. By 2020, we calculate that DPP will be cashflow-positive at the operating level and that it should be able to fund its expansion from internally generated resources in the following year.

Profit & Loss

Profit & Loss account

Year-end Dec (£m)	2016	2017	2018E	2019E	2020E
Core revenue	6.031	9.663	13.853	18.433	23.592
Other	1.526	0.715	0.000	0.000	0.000
Total revenue	7.557	10.378	13.853	18.433	23.592
Direct costs	-7.023	-9.659	-12.167	-15.548	-19.521
S,G&A	-2.114	-2.504	-2.761	-2.661	-2.996
UK expenses			-0.625	-0.625	-0.625
Pre-opening expenses	-0.048	-0.143	-0.083	-0.083	-0.092
Share-based payments	-0.353	-0.254	-0.208	-0.208	-0.208
Exceptionals (inc. FX)	-0.107	0.136	0.000	0.000	0.000
Depreciation, amort., impairment	-0.459	-0.657	-0.785	-0.824	-0.866
EBIT	-2.546	-2.703	-2.776	-1.516	-0.716
Finance income	0.065	0.093	0.036	0.016	0.002
Finance expense	-0.012	-0.024	-0.025	-0.025	-0.025
Loss before tax	-2.493	-2.635	-2.765	-1.525	-0.739
Tax			0.000	0.000	0.000
Net loss	-2.493	-2.635	-2.765	-1.525	-0.739
No. of shares					
- weighted	128.9	142.2	153	153	153
- fully diluted	128.9	142.2	153	153	153
EPS – basic (p)	-1.93	-1.85	-1.81	-1.00	-0.48
EPS – FD (p)	-1.93	-1.85	-1.81	-1.00	-0.48
EPS – FD adjusted (p)	-1.81	-1.85	-1.76	-0.94	-0.42
Group EBITDA	-1.580	-1.785	-1.700	-0.400	0.450

Source: Hardman & Co Research

Balance sheet

Balance sheet					
@ 31 Dec (£m)	2016	2017	2018E	2019E	2020E
Non-current assets					
Intangibles	0.443	0.558	0.608	0.658	0.708
P,P&E	2.766	6.618	7.583	8.259	8.893
Trade receivables	1.217	1.767	1.967	2.167	2.367
Total	4.426	8.944	10.159	11.084	11.968
Current assets					
Inventories	0.272	0.526	0.754	1.003	1.284
Trade receivables	1.818	2.581	2.068	2.600	3.200
Cash	6.308	4.506	2.323	0.209	0.117
Total	8.398	7.613	5.144	3.813	4.601
Total assets	12.824	16.556	15.303	14.897	16.569
Current liabilities					
Trade payables	-1.219	-1.649	-2.364	-3.146	-4.026
Provisions	-0.037	-0.037	-0.246	-0.454	-0.662
Borrowings	-0.073	-0.130	-0.118	-0.127	-0.150
Total	-1.329	-1.816	-2.728	-3.727	-4.838
Non-current liabilities					
Provisions	-0.051				
Borrowings	-0.234	-0.243	-0.843	-0.963	-2.263
Total	-0.285	-0.243	-0.843	-0.963	-2.263
Total liabilities	-1.614	-2.059	-3.571	-4.690	-7.102
Net assets	11.210	14.497	11.732	10.207	9.468
Share capital	0.685	0.763	0.763	0.763	0.763
Share premium	26.879	31.829	31.829	31.829	31.829
Retained earnings	-16.117	-18.500	-21.265	-22.790	-23.529
Other reserves	-0.237	0.405	0.405	0.405	0.405
Total equity	11.210	14.497	11.732	10.207	9.468

Source: Hardman & Co Research

Cashflow

Cashflow					
Year-end Dec (£m)	2016	2017	2018E	2019E	2020E
Loss before tax	-2.493	-2.635	-2.765	-1.525	-0.739
Depreciation, amort., impairment	0.459	0.657	0.785	0.824	0.866
Share-based payments	0.353	0.254	0.208	0.208	0.208
Finance	-0.053	-0.068	-0.012	0.009	0.023
Op. cashflows pre-working capital	-1.735	-1.792	-1.783	-0.483	0.358
Tax paid			0.000	0.000	0.000
Working capital changes	0.123	-0.445	1.000	0.000	0.000
Cash used in ops	-1.611	-2.237	-0.783	-0.483	0.358
Capex – P,P & E	-1.714	-4.132	-1.750	-1.500	-1.500
Capex – intangibles	-0.049	-0.050	-0.050	-0.050	-0.050
Lease deposits	-0.062	-0.050	0.000	0.000	0.000
Loans to sub-franchisees	-1.215	-0.502	-0.200	-0.200	-0.200
Disposal assets	0.699		0.000	0.000	0.000
Cash used investing	-2.341	-4.734	-2.000	-1.750	-1.750
Share issues	3.055	5.029	0.000	0.000	0.000
Net finance	0.024	0.068	0.600	0.120	1.300
Cash from financing	3.080	5.097	0.600	0.120	1.300
Increase/decrease in cash	-0.873	-1.874	-2.183	-2.113	-0.092
FX	0.193	0.071	0.000	0.000	0.000
Cash beginning	6.988	6.308	4.506	2.323	0.209
Cash end	6.308	4.506	2.323	0.209	0.117

Source: Hardman & Co Research

Board of Directors

Nicholas Donaldson – Non-executive Chairman

Nick, who is a barrister by profession, has worked in investment banking for over 25 years. He co-founded Capital Markets Group and is non-executive Chairman of Games Workshop plc, and an independent director of Fulham Shore plc. Until 2003, Nick was Head of Corporate Finance at Arbuthnot Securities. Prior to this, he was Head of Investment Banking in Europe for Robert W Baird, and previously Head of Corporate Finance and M&A at Crédit Lyonnais. Nick was, until 2007, a member of the FSA's Listing Authority Advisory Committee, which he joined on its inception. Nick has spent the majority of his career providing strategic advice to companies on M&A, flotations and secondary fundraisings.

Peter Shaw – Chief Executive Officer

Peter is co-founder of DP Poland and has been Chief Executive since October 2010. Peter started working in Poland in 2006, when he was appointed International Marketing Director for AIM listed Coffeeheaven International, Poland's leading coffee bar chain. Coffeeheaven was acquired by Costa Coffee in February 2010. With over 25 years' experience of working with consumer brands, Peter started his career in 1984 as a graduate trainee with Unilever's consumer research arm, Research International. In 1987, Peter joined Saatchi and Saatchi Advertising and, in 1992, he joined leading innovation consultancy CLK, where he helped major consumer brand owners develop their consumer offers.

Maciej Jania – Chief Financial Officer

Maciej is a highly experienced commercial manager with significant expertise in running both startup and established multi-site businesses. Maciej was co-founder and the Finance Director of Coffeeheaven International plc, Poland's largest coffee bar chain. In 2007, he moved to Samsung Electronics (Poland), where he held a senior financial position. In November 2010, Maciej was appointed Managing Director of DP Polska SA, DP Poland's wholly-owned subsidiary, which operates the Domino's Pizza Master Franchise in Poland. Maciej was appointed to the board of DP Poland plc in September 2012, in the role of plc Finance Director, which he fulfils alongside his Managing Director role.

Chris Moore – Non-Executive Director

Chris was Chief Executive Officer at Domino's Pizza UK and IRL, from December 2007 to December 2011, having joined that company in 1990 as European Marketing Manager. Chris is a recipient of the Domino's Pizza Chairman's Circle Award presented in July 2010, making him one of the top 15 individuals in the 50-year history of the company to receive this award. He has more than 22 years of experience working with Domino's Pizza and was responsible for growing the number of stores in the UK and IRL from 37 to 720. Chris advises and invests in a number of other businesses in the catering and online industries.

Gerry Ford – Non-Executive Director

Gerry Ford is Chairman and Chief Executive of Caffè Nero Group Limited, Europe's largest independent coffee house group. Gerry founded Caffè Nero in 1997, and listed the company on the London Stock Exchange (LSE) in 2001-07, before taking it private again. In 2005, he was named the UK's Entrepreneur of the Year by the Financial Times and LSE. Today, Caffè Nero has more than 5,000 employees in 700 stores across seven countries. Gerry is Chairman of the Polish subsidiary of Caffè Nero, which operates approximately 30 stores. Gerry has more than 20 years' experience of sitting on boards and nurturing small- and medium-sized businesses.

Robert Morrish FCA – Non-Executive Director

Rob is a Chartered Accountant, and has considerable experience at board level in small- and medium-sized businesses. He was previously a non-executive director of Coffeeheaven international plc and Group Finance Director of Supreme Petfoods Limited, and was the Chief Financial Officer of Lookfantastic.com, an online beauty product retailer and hair salon business. Rob has introduced and developed financial, costing and reporting systems for a diverse range of businesses, and has considerable practical experience in treasury, taxation and company secretarial matters.

Patrick Bodenham – Company Secretary

As well as supporting the Board in his role as Company Secretary, Patrick manages the day-to-day finance function of the PLC, including the preparation of the monthly UK management accounts, and the interim and full-year group accounts. Patrick is a Chartered Certified Accountant with over 20 years of accounting and taxation experience, and was part of the Coffeeheaven International team. He has been preparing published accounts for AIM-listed companies since 1997. Patrick is not a director of the company.

Risks

In addition to all the generic risks all businesses face, DPP has some specific threats. In the short term, food prices can squeeze profitability. With some of the competition not using real cheese, a price hike cannot be readily passed through without losing some competitive edge. Also, as mentioned above, DPP protects its franchisees against sharp rises in important commodities, of which cheese is the most important, as it represents around 30% of the cost of making a typical pizza.

All businesses face competition. DPP is no different, and has rivals with different strengths and weaknesses. We believe DPP's sole focus on pizza and delivery, allied with the quality of its product, puts it in a strong position to face down any competition – and this is as true of the food delivery aggregators as direct pizza competition.

One of the issues facing DPP when it is looking to grow its franchise business is finding suitable franchisees with finance to invest in a new store. The average cost of opening a new store is PLN 700k but, in addition to that, a franchisee needs to be able to fund the initial losses or low profitability. With its relatively short history of running a market economy, Poland does not have an enormous pool of budding entrepreneurs. Nevertheless, it is developing all the time and, in some cases, ex-pat Poles return with business experience gained in other countries.

DPP has raised equity finance regularly through its short life to fund the development of the business. It is hard to raise debt without a bedrock of profitability, although it does use finance leases for equipment needed in the stores. On our forecasts, it will finish 2020 with its cash resources almost depleted, but right at the turning point of moving to positive cash generation. This might prove too tight. As an alternative to finding new equity, DPP might be able to raise some debt finance against its profitable stores. It also has the option of slowing the opening rate if it needs to.

Notes

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