Cooks Global Foods

Initiation of coverage

Building a global coffee franchise

Food & beverages

Over the past six months Cooks Global Foods (CGF) has transformed from an NZX-listed shell into a global coffee franchise operator via the acquisition of a number of businesses related to the Esquires Coffee Houses franchise. The company is consolidating the Esquires brand under its ownership and is now embarking on a growth strategy to lift its presence from 78 stores currently to 580 stores by FY20. Our valuation of CGF is 27.5 cents per share, currently 62% above the share price.

Year end	Revenue (NZ$m)	PBT* (NZ$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
03/13	1.5	1.2	4.3	0.0	4.0	N/A
03/14e	4.6	(0.3)	0.5	0.0	24.3	N/A
03/15e	8.6	1.1	0.4	0.0	42.5	N/A
03/16e	12.6	2.3	0.7	0.0	24.3	N/A

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

A putative global brand

CGF's business plan is to significantly grow Esquires from its current 78 stores into a major international brand via a franchise model. The branded coffee chain sector is growing at around 10%+ a year in many countries, providing numerous opportunities for CGF to expand, even in mature markets such as the UK and US. China, India and the Middle East also present current and future growth opportunities at even faster rates. Store growth is expected to average 41% a year between FY14 and FY20. CGF will earn revenue from royalties paid by franchisees, sales of master franchises, and sales of coffee and other products to franchisees. Its costs will be largely focused on branding, business development, in-market franchisee support and administration.

Execution the key

Management's ability to develop CGF as an international business is critical to the company's success. The Deeks brothers are the driving force behind the company and have more than a decade of experience with the Esquires brand both locally and internationally. CGF will be operating across currencies with its NZ dollar share of revenue falling away as it grows; earnings will increasingly rely on the movement of a basket of currencies increasingly dominated by the Chinese yuan and US dollar, making currency/treasury management increasingly important.

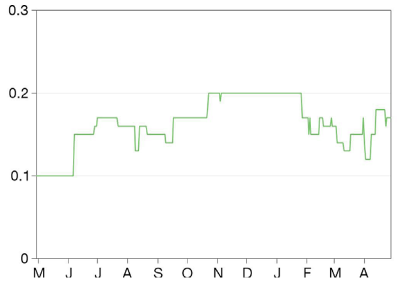
Valuation: Plenty of upside, however

Our DCF valuation is NZ$0.275 a share, some 62% above the current share price (based on a WACC of 10.6% and a terminal growth rate of 2.0%). However, that is predicated on growth to 580 stores by FY20. On an EV/EBITDA basis CGF is trading on a 28.5x 12-month forward multiple, well ahead of its peer group. This can be justified by its stronger near-term growth prospects compared to its peers.

29 April 2014

Price	**NZ$0.17**
Market cap	**NZ$44m**
	NZ$1.92/£
Net cash FY14 (NZ$m)	4.8
Shares in issue	259.4m
Free float	10.7%
Code	CGF
Primary exchange	NZAX
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	13.3	0.0	70.0
Rel (local)	14.0	(4.0)	57.4
52-week high/low		NZ$0.2	NZ$0.1

Business description

Cooks Global Foods owns the global rights to the Esquires Coffee House brand, with 56 stores currently operating in the UK, Ireland, China and the Middle East via master franchise arrangements. It is planning a significant expansion in store numbers over the next five years.

Next event

FY14 results	May 2014

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Investment summary

From shell to coffee house

Over the past six months CGF has transformed from a listed shell to the owner of the Esquires Coffee House brand, with 78 stores in eight countries. A series of acquisitions has consolidated the global franchise and a number of master franchises into one ownership structure, with the company now set on a path to grow to 580 stores by FY20 via a franchise model.

Branded coffee houses worldwide continue to grow well ahead of broader retail sales, with Allegra Strategies[1] forecasting sales of UK-branded coffee chains to grow at 10% a year through 2018. HSBC predicts 19% a year growth in China through 2030, and in most markets where CGF currently operates, or proposes to, the growth rates are in that range.

A cash-flow generative business

CGF is a high cash-flow business, earning royalties from its franchised stores, selling coffee and other products and generating fees from new master franchises and store openings. Its costs are largely based around franchisee support, training, marketing and branding.

Our analysis suggests that the company could generate EBITDA margins of around 25% by FY19/20 (from zero in FY14e) and convert most of that into net earnings (see Exhibit 1). Our DCF valuation is NZ$0.275 per share based on a WACC of 10.6% and a terminal growth rate of 2.0% (see Valuation section).

Given that the acquisitions were relatively recent, CGF still has to prove that it can successfully operate this business and grow it as planned, although early indications are encouraging.

Exhibit 1: Earnings projections

NZ$m	FY14e	FY15e	FY16e	FY17e	FY18e	FY19e	FY20e
Year End Store Numbers	78	136	215	303	398	489	580
System Sales	26.0	39.3	70.7	112.2	163.4	220.0	281.9
Total CGF Revenue	4.6	8.6	12.6	17.2	21.8	26.6	32.0
EBITDA	(0.1)	1.3	2.4	3.6	4.9	6.8	8.8
PBT	(1.8)	1.1	2.3	3.6	5.0	6.9	9.2
NPAT	(1.2)	1.0	1.8	2.8	3.8	5.3	6.9
Sales/Store/Week (in NZ$)	n.a.	7,067	7,742	8,331	8,963	9,539	10,143
Estimated Number of Sales Day/Store	n.a.	133	146	157	168	179	191

Source: Edison Investment Research. Note: System sales are gross sales from all Esquires stores and are used for the royalty payment calculations.

Sensitivities

- Execution is the key issue, with management needing to control an increasingly internationalised business.
- CGF will also be exposed to competitive pressures, especially from established operators seeking to build their customer loyalty through increasingly sophisticated social media and engagement strategies and from new entrants offering novel food and beverage combinations.
- CGF will be increasingly exposed to a range of currencies as its business expands and diversifies across geographies.
- A further area of focus will be group cash flow management.
- We note that at present stock liquidity is low.

[1] Allegra Strategies: UK Retail Coffee Shop Market – December 2013

Company description: From shell to coffee operator

CGF is a coffee franchise business with 78 Esquires stores currently in operation in eight countries. The company plans to expand significantly over the next five years to operate 580 Esquires stores by FY20. It aims to achieve this by selling master franchises and earning royalties on sales by franchisees and sales of coffee and other products.

CGF listed in October 2008 as Cooks Food Group with a market capitalisation of less than NZ$10m and a business plan to acquire a portfolio of food manufacturing business; at the time it owned two small food manufacturers and planned to acquire two more. The company did not raise capital at listing; rather it switched from an unlisted to a listed public company. The plan to acquire the food manufacturers was defeated by the inability of the company to raise further capital following the global financial crisis.

Between mid-2009 and mid-2013 little appeared to be happening with the company. However, in August last year CGF announced it was acquiring a number of businesses related to the Esquires Coffee House franchise, including the global franchise rights and the master franchises in Ireland, the UK, China and the Middle East. It also acquired a kiwifruit juice company in New Zealand (NZ$250,000 in shares) and raised net NZ$3.1m in cash.

Exhibit 2: Acquisition of Esquires by CGF

Business acquired	Consideration shares issued (m)	NZ$m value	Cash	Total
Franchise Developments Ltd	136.349	13.635	0.300	13.935
Esquires UK	2.442	0.366	1.765	2.131
Esquires Ireland	1.194	0.179	0.350	0.529
Progressive Processors	2.500	0.250	-	0.250
Sub-Total	142.484	14.430	2.415	16.845
Shares issued for cash	47.972		5.500	5.500
Conversion of convertible shares	7.398	0.740		0.740
K Jackson Debt/Fees Owing	23.427	3.349		3.349
Total	221.282	18.519	3.085	26.434
Pre-transaction shares in issue	27.577			
Post transaction shares in issue	248.859			

Source: Simmons Corporate Finance – Independent Advisers Report

The company also acquired the global rights to the Esquires brand in April 2013 for C$1.3m (NZ$1.38m). Shareholders approved the transactions in October 2013, with some 209m new shares being issued to vendors of the franchise business, repayment of loans and satisfaction of debts owed. In effect the acquisition saw the reverse listing of the Esquires franchise business; prior to the transaction CGF had no operating businesses and was a listed shell company.

A putative global branded coffee house chain

Esquires was founded in Vancouver, Canada, by two friends, with the opening of the first store in 1993. A franchise business was developed over the next few years with master franchise rights sold in the UK, New Zealand and Australia and further stores opened in Canada. The Deeks brothers, Lewis and Stuart, acquired the rights to New Zealand and Australia in 2001 and grew the franchise from one store in Auckland to 46 stores across New Zealand by the end of 2010.

During the latter part of this period the Deeks also secured or helped arrange master franchises for China, the Middle East and India. In December 2010 the Deeks sold their New Zealand/Australia franchise to Retail Food Group (RFG.AX) for A$9m and entered into a restraint of trade that expired in February 2014. The sale by the Deeks occurred in response to an attractive offer and a desire to focus their efforts on broader international expansion of the Esquires brand.

As at February 2014 there were 132 Esquires stores worldwide, with 78 under the CGF umbrella GF and 54 controlled by Retail Food Group. Exhibit 2 shows the breakdown by geography and owner. CGF has acquired the master franchise rights to Canada, however, the transaction sees the existing franchise owner continue on a royalty-free basis for the stores it currently operates, with CGF free to open new stores in provinces and cities where the current operator is not present.

Esquires is somewhat different from most multi-country coffee house chains as it does not have a large domestic base in any one country. For example, Costa Coffee, a unit of Whitbread (WTB.LN), had 1,360 stores in the UK compared to 1,060 stores internationally at September 2013, while Starbucks (SBUX.US) has 13,493 US stores compared to 6,274 internationally. In contrast, New Zealand currently has the most Esquires stores and it sits outside the control of CGF.

Exhibit 3: Esquires branded stores by country

March 2014 stores		Master franchisees controlled by
UK	28	Cooks Global Foods
Ireland	6	Cooks Global Foods
Middle East	16	Various
China	14	Yunnan Metropolitan Construction Investment Co
Canada	14	Esquires Coffee Houses, Inc
Subtotal – Cooks Global Foods	**78**	
NZ	49	Retail Food Group
Australia	5	Retail Food Group
Subtotal – others	**54**	
Total	**132**	

Source: Cooks Global Foods, company websites

The branded coffee market

The branded coffee market has developed significantly over the past 15 years as consumer tastes and food/beverage consumption patterns have changed. The rise of quick service restaurants (QSRs) and the plethora of convenience food outlets have seen takeaway food and drinks become the norm for many urban dwellers.

At one time out-of-home coffee consumption was the preserve of filter coffee machines in offices and tearooms, and was uniformly bad. However, since the ‘arrival’ of the espresso machine on British and US shores, consumers have shifted steadily away from the ‘stewing black tar’ sitting in the coffee machine to a range of higher-quality (and more pricey/profitable) European style-beverages.

Coupled with the shift in consumer preferences a range of branded coffee houses have developed to cater for consumer needs, mostly operated under franchise arrangements. The most popular names include Starbucks, Dunkin’ Donuts, Café Nero, Tim Hortons, Costa Coffee and Caribou Coffee Company.

A key feature of the branded coffee chain market in almost all countries over the past few years has been the pace of sales growth compared to broader retail spending; it has been one of the few bright spots and is generally forecast to continue to deliver faster sales growth than broader retail sales for the foreseeable future. Allegra Strategies noted that for 2013 the branded coffee chain market in the UK grew sales by 9.3% compared to broader UK retail sales growth of 2.3%. The same pattern occurred in 2012 with the branded coffee chain market growing by 10% compared to 1.0% for broader UK retail sales.

Allegra Strategies forecasts UK sales to grow at 10% pa through to 2018. HSBC expects China sales growth to be 19% pa through to 2030, with other markets between the two.

One of the trends helping to drive this growth is the broadening of offering away from just coffee to a range of other beverages and food products. Research from Allegra Strategies shows that the longer customers are in a coffee house, the more they spend. Consumers and business people (shoppers and office workers) increasingly use coffee houses as meeting and business places, with a stay over 45 minutes generating almost twice the revenue of a short stay.

In China, for example, the coffee house is seen as a popular place for younger couples to meet, with free Wi-Fi being a distinct marketing advantage. While no operator likes a customer occupying a seat all day with just one coffee, the data shows that average spend in markets like China is estimated to be some 35% higher than average spend in the UK.

Exhibit 3 shows the difference in CGF's transaction values and number of transactions by country. Currently the system sales are dominated by the UK accounting for 58% of system revenue, albeit with the lowest transaction value. As CGF expands its store presence into higher-value Middle Eastern and Chinese markets the average transaction size is increasing; between March 2013 and January 2014 CGF's average transaction size already increased from NZ$7.73 to NZ$8.42, or an annualised growth rate of 10.7% reflecting that expansion.

Exhibit 4: FY14 transaction data by country

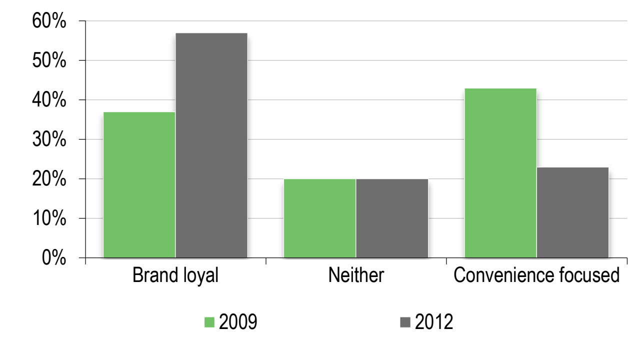
Country	Transaction value, NZ$	Transactions per week
Ireland	11.45	8,897
Bahrain	10.45	904
China	9.73	5,797
Kuwait	9.05	605
United Arab Emirates	8.92	1,506
Saudi Arabia	7.47	4,369
United Kingdom	7.23	41,732
Average	8.16	63,810

Source: CGF

Convenience and store location have been the major factors in consumer choice of coffee shop, however, brand and coffee quality are becoming increasingly important.

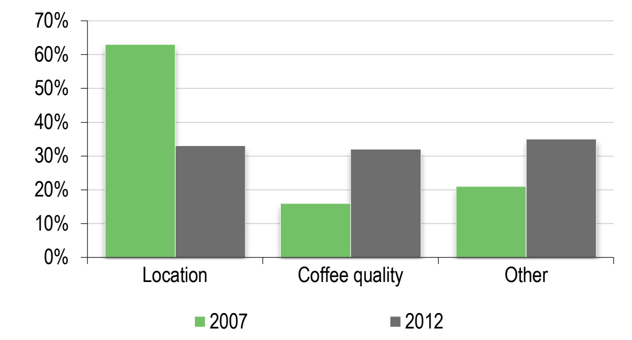
Exhibit 4 shows that brand loyalty has increased markedly in the UK between 2009 and 2012, with a similar percentage drop in consumers' focus on convenience. Similarly, Exhibit 5 shows that location has dropped by half as a reason for the choice of shop, with coffee quality more than doubling in importance and other factors making up the balance.

Exhibit 5: Brand loyalty vs convenience



Source: Allegra Strategies

Exhibit 6: Reason for choice of shop



Source: Allegra Strategies

Growing the store network/brand

A major element of the business plan a straightforward roll-out, aimed at growing the number of stores to establish Esquires as an identifiable brand in each market that it operates. We illustrate related issues through the example of the UK market, currently CGF's largest. As Exhibit 6 shows, Esquires has a UK market share of 0.9% and ranks number seven among coffee-focused UK stores. The UK market has a high Herfindahl index with the top three firms accounting for over 87% of revenue and over 78% of store numbers in 2012.

Management considers that it needs a market share (measured in terms of number of outlets) of at least 2.5% and ideally 5.0% in each market. Based on Allegra Strategies' 2013 report for the UK, to achieve 2.5% market share Esquires would need 139 stores, compared to the 28 it has now. A 2.5% market share would see Esquires ranked at number four.

Exhibit 7: 2012 UK market share – coffee-focused operators

Operator	Number of stores	Market share %	Turnover share %	Delta
Costa Coffee	1,552	42.8%	44.1%	1.3%
Starbucks	757	20.9%	28.5%	7.6%
Café Nero	530	14.6%	14.6%	0.0%
AMT Coffee	53	1.5%	1.4%	-0.1%
Caffe Ritazza	47	1.3%	0.8%	-0.5%
Café Thorntons	37	1.0%	0.7%	-0.3%
Esquires	**32**	**0.9%**	**0.7%**	**-0.2%**
Puccino's	28	0.8%	0.3%	-0.5%
Coffee #1	26	0.7%	0.5%	-0.2%
Coffee Republic	22	0.6%	0.5%	-0.1%
Others	538	14.9%	7.9%	-7.0%
Total	3,622	100.0%	100.0%	0.0%

Source: Allegra Strategies

The delta illustrates an important point about growing store numbers and brand power. The operators with largest market shares have a higher share of turnover (thus profitability) than the rest, with the 'Others' having a significantly smaller share of turnover compared to store numbers.

However, in China the market is growing so rapidly that it is difficult to accurately determine its true size. CGF has ambitious plans for China, but then so does every other coffee operator. For example, Starbucks grew its China presence by over 45% in FY13 to 1,017 stores and has announced plans to open a further 1,500 stores over the next few years. Costa Coffee had 307 stores at September 2013 with plans to increase this to more than 700 by 2018, while Gourmet Master of Taiwan (2723.TT) plans to increase its store numbers by 38% over the next 18 months.

There are three strategies that CGF can employ to grow the number of stores: organic growth, new master franchises for new territories and acquisitions.

Organic growth

Each master franchisee has minimum performance obligations (MPOs) to CGF in terms of the number of stores being opened each year. For example, in the recent announcement of the Oman and Qatar master franchises the franchisees have an MPO to open eight stores in each country over the next five years.

Exhibit 8: Estimated store numbers

	2014	2015	2016	2017	2018	2019	2020
UK	28	34	44	54	64	74	84
Ireland	6	9	13	17	21	25	29
Saudi Arabia	9	12	16	19	23	27	31
Bahrain	2	4	6	8	10	12	14
UAE	3	5	7	9	12	14	16
Kuwait	2	4	8	12	16	17	18
Oman	-	1	3	5	6	8	10
Qatar	-	2	3	5	7	8	10
China	14	40	70	100	130	160	190
United States	-	5	18	40	68	96	124
Canada	14	20	27	34	41	48	54
Total	78	136	215	303	398	489	580

Source: Edison Investment Research estimates, CGF

As noted above, to achieve a 2.5% share, CGF would have to open more than 100 new stores in the UK based on 2013 data. However, Allegra Strategies projects that store numbers will grow by over

5% a year through to 2018, making the target by 2018 closer to 150 new stores to achieve that share. Our projected store numbers show CGF having 84 stores in FY20 (see Exhibit 8).

Organic growth is the easiest to secure as franchisees fund store development costs, running at c NZ$200,000 per store. CGF earns an opening fee of NZ$10,000 for each new store and may sell store design and consulting services to franchisees. CGF has developed a standard store layout model that can be localised from various mix-and-match components; thus the model is a standard look and feel, but with localised embellishments suitable for individual markets or locations.

Typically the master franchise holder will lease the premises, sub-letting it to the operator. Based on data provided by CGF, stores mature fairly quickly from opening, with most stores reaching a steady state after six months. We expect that on a turnover of NZ$500,000 a year, the operator will be able to generate an EBIT of NZ$80,000. Assuming 50% of the development costs are borrowed at an interest rate of 10%, the pre-tax earnings of the store will be NZ$70,000 (14%). Note that a turnover of NZ$500,000 is equivalent to 168 transactions per day at the average value of NZ$8.16.

CGF advises that so far it has not had any problems with payments from master franchisees or operators. As noted elsewhere the Deeks brothers have over a decade of experience in franchisee management and have good systems to manage and communicate with franchisees and operators.

Master franchises

CGF is actively pursuing the sale of master franchises in a number of countries, although the timing of these is difficult to forecast. It has disclosed intentions to sign master franchises in Turkey, Singapore, Malaysia, the US, Pakistan and Myanmar and a number of other undisclosed markets.

CGF considers that a ratio of one store to 11,000 people can be used for mature markets (US/UK/Canada), one store to 50,000 people in developing markets such as the Middle East, while one store to 200,000 people is likely to be appropriate in China.

CGF will typically sell a master franchise for NZ$400,000, although it may only cover part of a country or region, depending on CGF’s assessment of likely demand. In some cases it may sell a master franchise for an entire country with the right to split the franchise into several master franchises as store numbers grow. This has already happened in the Middle East where CGF has gone from one master franchise for the region to one master franchise per country.

There is also work being done to improve or restructure some of the existing master franchises to improve performance, or to split existing master franchises into smaller units. As noted above this has already happened in the Middle East and the company has plans to sell further master franchises in the region.

A master franchise was sold for India in 2008. However, no stores have been opened. CGF is working with the existing franchise holder– which has no further interest in the franchise – to sell it to a new operator, which will then advance the roll out of Esquires in India. What this looks like in terms of store numbers, revenues and earnings is still unknown. However, as with a number of other Asian nations, India is seeing strong growth in branded coffee sales, albeit off a low base. The leading Indian branded coffee chain is Café Coffee Day with 1,320 stores, and it has plans to increase this to over 2,000 in the near term, with the overall market growing by more than 10% a year.

In our view the US market is one where CGF is likely to sell state-based or even city-based master franchises as an alternative to organic growth, to enter the market and grow quickly, subject to competition. Although the US is a mature market, major operators such as Dunkin’ Donuts and Tim Horton’s still see plenty or room for growth. For example, Dunkin’ Donuts has over 7,500 stores in the US, but has less than 300 stores west of the Mississippi. Tim Horton’s US stores have been concentrated around the New England states; however, it is now looking to expand into the mid-western states.

Both Dunkin' Donuts and Tim Horton's are many times larger than CGF; however, their continued drive into the US suggests there are also room for others, and a start on the west coast where there is relatively little competition from the US majors (Starbucks excepted) appears to be a good strategy.

Also, as noted above CGF will sell master franchises in Canada, in particular in the eastern provinces (more populous) following its agreement with the existing Canadian franchise holder, which will retain the rights to Alberta and some parts of Vancouver on a royalty-free basis.

Another option exists in that CGF could act as a master franchisee for another brand and in effect run a multi-brand strategy in some markets. This would have some operational benefits in terms of cost management, supply pricing and infrastructure, although CGF is not thought to be pursuing such a strategy at the moment.

Acquisitions

The third option for CGF to expand is to acquire other franchise operations. The Deeks are now free of their restraint of trade on operating branded coffee houses in Australia and New Zealand; thus these two markets are an attractive starting point given that they know these markets so well.

CGF could approach Retail Food Group to determine if it would sell its Esquires master franchise. This would make some sense as this master franchise is the only one not currently controlled by CGF, although whether this is possible, and at what price, is unknown.

Another possibility would be to acquire an existing franchise brand outright and operate it as a second brand in just Australia and New Zealand. This would give CGF exposure to its 'home' market, although it would mean running a separate brand strategy for just these two markets.

More broadly in other markets, CGF could acquire an existing franchisee or sub-franchisee operating another brand. This would give the company immediate scale with a plan to transfer the branding from the acquired brand to Esquires over time. As with any retail business, location and points of presence are important, so it makes sense for CGF to be looking at options to secure well-located sites even if it means operating a competitor brand for a time until it can be switched to Esquires.

Brand innovations

To continue to drive growth, most of the major branded coffee chains are investing in product and loyalty innovations. Over time, same store sales growth (SSSG) is very closely matched with the rate of inflation, so chains are constantly seeking new product and consumer engagement ideas to lift per store sales or extend the brand beyond the shop into the office and/or home. For example, Costa Coffee operate over 3,300 standalone machines in offices and public areas, Starbucks offers its own branded coffee for sale for in-home use, and many chains offer increasingly sophisticated loyalty and social media programmes to engage with consumers.

An issue for CGF is its ability to manage product and consumer engagement innovations that allow it to keep pace with competitors. At present Esquires profiles as somewhat 'standard fare' in comparison to some of the efforts of its competitors in markets such as the UK. However, it should be noted that CGF is only partway through the process of bringing all its master franchisees under one consistent branding and standards banner. For example, CGF has recently announced its Scarborough Fair tea brand is going to be deployed through all Esquires stores.

Some competitors offer phone applications that allow customers to pre-order coffee and other products and simple payments via swiping their Oyster cards (and the like). Apps, Facebook and

Twitter are used for product promotions and engagement strategies. CGF is working on these aspects of its branding strategy.

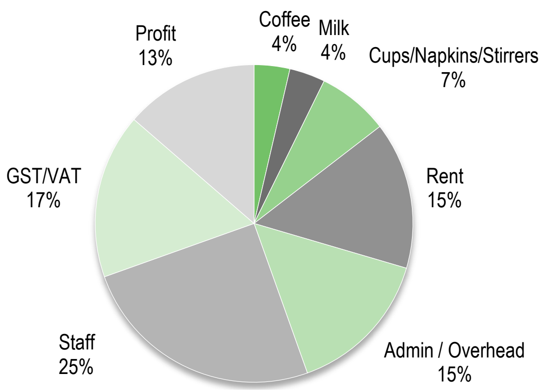
Another area is food and beverage innovations. Many competitors are focused on offering different products for different ‘day parts’ and new beverage mixes/combinations. Esquires’ offering at present appears to be more ‘standard fare’ than innovative, although that is not necessarily a bad thing; Allegra Strategies notes that the most common purchases focus on a small range of standard products. The most common coffee beverage is the cappuccino, with the most popular food product a sweet muffin. At the other end of the scale, Starbucks proudly declares on its website that it offers over 87,000 drink combinations.

Coffee house economics

Cost model

From franchisees’ perspective, the price of coffee is probably one of the things they have to worry about the least. Exhibit 9 below shows the cost breakdown of a typical cup of coffee in the UK.

Exhibit 9: Cost breakdown of a cappuccino at the counter



Source: Allegra Strategies

Coffee makes up 4% of the total price, indicating that consumers and franchisees are not overly exposed to shifts in its price, with costs such as labour, energy, rent and other supplies more relevant in terms of profitability. Milk also makes up 4% of total costs; thus the beverage raw materials cost (including cups, stirrers, napkins) typically represents under 15% of the retail price.

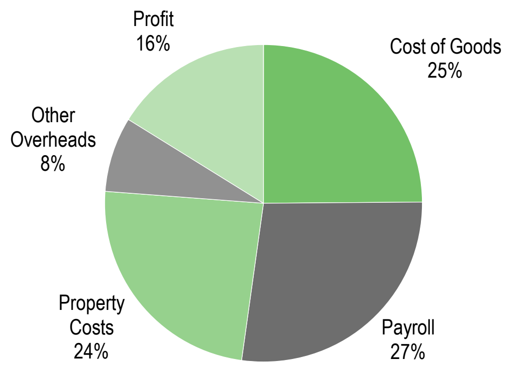
The royalties paid by franchisees are included in the admin/overhead slice shown above. CGF royalties vary depending on whether it is also the master franchisee (see Exhibit 2). Where CGF is also the master franchisee it receives 8% of gross sales, but where a third party is a master franchisee it receives 4% (the master franchisee taking the other 4%). CGF also earns margin on coffee supplied, typically around NZ$10/kg, and further margin on products sold to franchisees.

The two charts below set out a cost model based on market data for 26 typical stores in the UK, provided by CGF. The UK market is currently CGF’s largest and has the most data available.

Exhibit 9 shows an aggregate breakdown of the major cost categories across all 26 stores, while Exhibit 10 shows the average across all 26 stores as well as a range of one standard deviation.

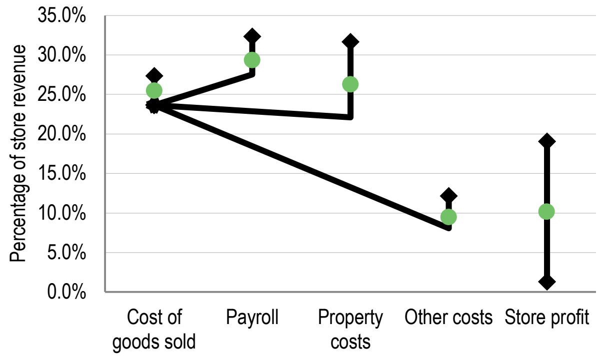
The cost of goods sold is the least variable, showing the smallest standard deviation with the aggregate percentage (Exhibit 9) and average percentage (Exhibit 10) about the same. This suggests that food and drink costs are quite variable, whereas other cost categories have higher levels of fixed costs, hence the wider range in the standard deviation. Unsurprisingly, as the residual, profit has the widest standard deviation of all.

Exhibit 10: UK/Ireland stores' aggregate cost structure



Source: CGF Data

Exhibit 11: Cost structure based on average store - average plus range of 1 standard deviation



Source: CGF Data

Coffee sales

CGF's coffee sales are expected to be around 44 tonnes in FY14, rising to over 476 tonnes by FY20. Currently the company outsources all roasting to two operators, in the UK and New Zealand.

We estimate that by using third-party roasters CGF is leaving approximately NZ$5/kg on the table, or around NZ$220,000 for FY14, which by FY20 could rise to NZ$2.4m. Currently the roasting arrangements appear to work well, thus the question is whether this increment in gross margin is large enough to justify the management time and cost against a background of rapid international expansion. The incremental gross margin works out to around 4.6% in FY14 and 7.0% in FY20; certainly nice to have, but maybe not enough to justify changing the current arrangements.

Another issue is volatility in the coffee price. CGF is currently buying from roasters so it has an indirect exposure to movements in the coffee price. We expect that CGF will have an ability to pass on any increase in its coffee purchase price and thus protect its margin, with the franchisees and store operators absorbing the cost directly.

Progressive Processors and Scarborough Fair

CGF acquired Progressive Processors at the time of the acquisition of the Esquires businesses and acquired Scarborough Fair in October 2013. Progressive manufactures fruit juices, primarily kiwifruit at present, and sells primarily to third parties. CGF's intention is to create its own juice brand using Progressive as the manufacturer/supplier. Progressive's sales were around NZ$1.4m in FY13. However, with the expansion of the Esquires network, sales are expected to grow quickly.

Scarborough Fair was acquired to gain access to a tea brand that could be rolled out across the Esquires store network. Scarborough Fair's turnover in FY13 was around NZ$600,000, so it is quite a small business compared to the system sales of CGF. However, with CGF announcing that the brand will be rolled out across the CGF network, sales are expected to grow quickly.

Although CGF is primarily a franchise business, it does have skilled food manufacturing expertise in its senior management ranks.

Both acquisitions underscore CGF's desire to control more of the food/beverage flow to its franchisee and store operators. As described above it has its coffee roasting arrangements in place and investors should expect that further acquisitions or investments in other food and beverage products will occur.

Management and board

CGF has a board of six comprising three executive directors and three independent directors.

Keith Jackson, executive chair, was formerly CEO of Tegel Foods, a New Zealand-based chicken manufacturer, and investor in a number of other food businesses, particularly in the dairy sector. Keith founded CGF in 2008 and his role with the company is essentially that of CEO. He is also responsible for the UK and Irish operations.

Stuart Deeks, executive director, founded and developed the Esquires chain in New Zealand with his brother Lewis before selling it to Retail Food Group in early 2011. He was also involved in entering into master franchise agreements for the Middle East, India and China. More recently he has been involved in acquiring global intellectual property rights and in acquiring the UK and Irish master franchises. His role with CGF will be business development, looking to expand the store network through master franchises and supporting existing master franchisees' growth plans.

Lewis Deeks, executive director, was instrumental in the development and implementation of all franchise systems, supplier relationships, operational aspects and infrastructure within the Esquires business. These systems provided the core principles behind Esquires' New Zealand's success in twice being awarded Food and Beverage Franchise System of the Year. His role with CGF will be again focusing on operational issues.

Andrew Kerslake, independent director, was previously involved in the logistics industry, but over the past 10 years has become an investor and entrepreneur.

Mike Hutcheson, independent director, has a background in the advertising, publishing and media industries, serving for a time as CEO of Saatchi and Saatchi New Zealand.

Norah Barlow, independent director, was formerly managing director of Summerset Group, an NZX-listed retirement village operator, and has a background in accounting.

CGF has 30 staff in its corporate team, with 17 staff in its Auckland, New Zealand office, 11 in Ireland and the UK, and two in the Middle East. The company is currently recruiting a CFO and additional support staff for Stuart Deeks. As further master franchises are sold/developed additional corporate staff will be employed 'in market' focused on administration, systems, training and brand development.

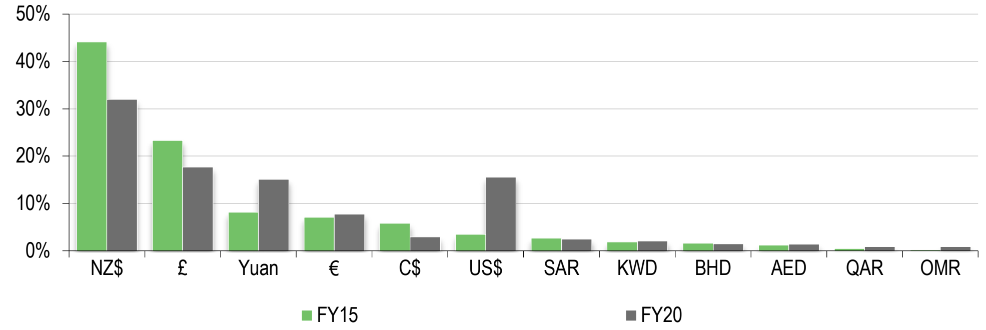
Sensitivities

Business plan execution: Business plan execution is the key issue for CGF and investors. Management needs to control and grow an increasingly international business with a diverse range of master franchisees in different legal and operational environments. Related issues include brand consistency and compliance, property management, protection of intellectual property, bad debts, etc. The Deeks brothers have been successful in growing the Esquires brand in Australasia and have helped develop its presence in the Middle East and China. As noted above, GCF has over 40 staff, with over 25 located outside New Zealand. The company will need to continue to attract talented and committed executives to key management roles in all markets, to enable it to reach its business plan goals.

Competition: In each market, CGF faces many competitors, some having been entrenched for some time and others being local brands that have grown quickly. Café Coffee Day in India is an example of a home-grown brand that is expanding quickly, while western brands such as Starbucks, Dunkin Donuts and Costa Coffee are also expanding rapidly in China, the Middle East, southern Asia and Europe. In all markets CGF needs to generate brand acceptance and that requires rapidly growing its store network/points of presence to capture consumers' attention.

Exchange rates: A key sensitivity is to exchange rates, related to both the sale of products (coffee/tea/juices) to franchisees and the conversion of reported revenue back into New Zealand dollars. For FY15, 44% of CGF's revenue is expected to be in NZ dollars; however, by FY20 this is projected to have fallen to 32%, with the Chinese yuan and US dollar growing from a combined 11% in FY15 to 31% in in FY20 (see Exhibit 11). CGF will need to develop currency and treasury management skills to effectively manage its exchange rate exposures.

Exhibit 12: CGF currency exposure changes



Source: Edison Investment Research estimates

Cash/tax management: CGF also needs to develop full treasury management to effectively manage cash between its different operations/countries. CGF may be caught with punitive withholding taxes on movement of cash from various countries in which it operates or intends to operate. Further, the company will need to develop sophisticated tax management plans to ensure profits can be moved around its various operations, particularly in the Middle East and Asia.

Stock liquidity: CGF currently has a free float of 11% with the Deeks Brothers, Keith Jackson and various vendors holding 76.2% of the outstanding shares. The company is addressing its stock liquidity through a share purchase plan (SPP) that is expected to raise NZ$6.75m, although this has been deferred twice now. There is also the possibility of placements and further share issues for acquisitions that will increase the number of shares on issue and possibly the free float.

Financials

Earnings

CGF acquired the Esquires business in October 2013, thus the results for FY13 reflect its status as a cash shell at that time, while the forthcoming results for FY14 only reflect Esquires for five months, thus our focus is on the forecasts for FY15 onwards.

CGF's revenues are generated from three sources: **store revenues** including royalty payments, sales of coffee and other supplies such as cups, napkins, stirrers and syrups, **franchise development** revenue from the sale of master franchises and store opening fees, and **product sales** from Progressive Processors and Scarborough Fair to third parties and to Esquires store operators.

Exhibit 13: Earnings projections

NZ$ millions	FY14e	FY15e	FY16e	FY17e	FY18e	FY19e	FY20e
Year End Store Numbers	78	136	215	303	398	489	580
System Sales	26.0	39.3	70.7	112.2	163.4	220.0	281.9
Total CGF Revenue	4.6	8.6	12.6	17.2	21.8	26.6	32.0
EBITDA	(0.1)	1.3	2.4	3.6	4.9	6.8	8.8
PBT	(1.8)	1.1	2.3	3.6	5.0	6.9	9.2
NPAT	(1.2)	1.0	1.8	2.8	3.8	5.3	6.9
Sales/Store/Week in NZ$	n.a.	$ 7,067	$ 7,742	$ 8,331	$ 8,963	$ 9,539	$ 10,143
Estimated Number of Sales Day/Store	n.a.	133	146	157	168	179	191

Source: Edison Investment Research. Note: System sales are gross sales from all Esquires stores and are used for the royalty payment calculations.

We forecast underlying SSSG to be 3% a year in the UK and Ireland, 8% in China and 5% in the Middle East. Because of the changing store mix towards higher growth markets over the forecast period the underlying SSSG for CGF is expected to be 5.4%. This is reflected in increases in the average transaction value and underlying expectations for inflation in these markets.

Operating costs include the cost of goods sold for Progressive Processors and Scarborough Fair and the corporate overheads of the group, the master franchise operations in the UK and Ireland, and brand development costs. Note that the master franchisees will also carry their own brand compliance, training, marketing and property costs. Depreciation is expected to remain at around NZ$200k due to the small fixed asset base of the company and interest is expected to remain positive, as CGF is not expected to pay dividends for the foreseeable future.

Balance sheet

The main asset in the near term will be the goodwill acquired on acquisition, with fixed tangible assets running at around NZ$2m and working capital rising from NZ$1m in FY15 to almost NZ$3m in FY20. We expect FY14 net cash to be NZ$4.8m with NZ$25.3m of intangibles. These two items are expected to make up 90% of total assets for FY14. Net cash is expected to be $24.2m by FY20, up from NZ$5.5m in FY15, assuming that no dividends are paid out. CGF's post-tax ROIC is projected to be 2.5% in FY15 rising to 18.0% by FY20, compared to its WACC at 10.6%.

Cash flow

CGF's operating cash flow is expected to be NZ$0.9m in FY15 rising to NZ$8.3m in FY20, with investing cash flow expected to run at around NZ$200k a year; thus a high and increasing proportion of the operating cash flow will flow through to cash holdings. CGF's main use of cash will be working capital, which is expected to equal 15.1% of turnover in FY15 falling to 9.8% in FY20. This low level of working capital to revenue is due to a large portion of the company's revenue coming from royalties and fees, which are payable immediately.

Valuation

DCF

Our primary valuation method is DCF. Exhibit 13 below sets out the projected free cash flows through until 2020. A key feature of this business is that store expansions are funded by franchisees, thus the capex requirement of CGF are largely its own head office capex and that of Progressive Processors and Scarborough Fair.

Exhibit 14: Estimated free cash flows

NZ$ (000)	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24
EBIT	(320)	1,015	2,104	3,356	4,644	6,506	8,589	10,307	11,853	13,039	13,691
- Tax	90	(284)	(589)	(940)	(1,300)	(1,822)	(2,405)	(2,886)	(3,319)	(3,651)	(3,833)
+ Depreciation	194	248	253	261	255	251	246	246	246	246	246
- Capex	(372)	(279)	(294)	(206)	(204)	(203)	(203)	(203)	(203)	(203)	(203)
+/- Working Capital	-	(408)	(376)	(405)	(373)	(430)	(565)	(246)	(282)	(311)	(326)
Free Cash Flow	(407)	291	1,097	2,067	3,022	4,302	5,662	7,219	8,295	9,120	9,574

Source: Edison Investment Research estimates

Exhibit 15 below sets out the DCF and the key valuation input parameters:

Exhibit 15: Discounted cash flow valuation

DCF valuation NZ$000		Valuation parameters	
Forecast period	26,086	Asset Beta	1.01
Terminal value	39,330	Equity Beta	1.01
NPV to capital	65,416	Gearing	0.0%
Net debt/(cash)	(4,807)	WACC	10.6%
NPV to Equity	70,224	Cost of Equity	10.6%
Value per share	$ 0.275	Terminal growth rate	2.0%

Source: Edison Investment Research

Our asset beta estimate is derived from the peer group shown in Exhibit 15. We have assumed that CGF continues to have net cash on its balance sheet over the forecast period, thus the WACC is the same as the cost of equity.

Our DCF valuation is sensitive to exchange rate movements. Our financial model is based on no change in exchange rate over the forecast period. However, a 1% a year depreciation of the NZ dollar against the other currencies would see the DCF valuation increase by 14.0%. A 1% increase in underlying market growth would only increase the DCF valuation by 2.6%.

If CGF were to expand faster, for example by opening 700 stores by FY20 (another 120 stores or an increase of c 20%), the DCF valuation would increase to NZ$0.329. However, if store openings were slower by 120 stores (460 open rather than 580) then the DCF valuation would fall to $0.234. Our terminal growth rate assumption is 2.0%. If this were 1.0%, our DCF valuation would fall to NZ$0.258; however, if the terminal growth rate were changed to 3.0% our DCF valuation would rise to NZ$0.297.

Peer valuation

Exhibit 16 below sets out the peer valuation metrics for branded coffee houses using 12-month forward valuation metrics.

Exhibit 16: Peer valuation comparison

Company	Currency	Price	Mkt cap m (local)	EV/EBITDA times	Net Debt/EBITDA	P/E (x)	Price / BV
Cooks Global Foods	**NZ$**	**0.17**	**44**	**28.5**	**(4.2)**	**41.6**	**1.3**
Starbucks Corp	US$	71.15	53,782	13.4	0.1	24.1	8.7
Dunkin' Brands Group	US$	49.07	5,231	16.4	3.7	25.7	11.1
Green Mountain Coffee Roasters	US$	98.67	15,964	12.6	(0.7)	25.5	5.4
Tim Hortons inc	C$	61.36	8,478	11.0	1.4	18.3	11.8
Retail Food Group	A$	4.17	604	9.9	0.8	14.1	1.9
Café Dr Coral Holdings	HK$	23.45	13,562	10.6	(1.0)	19.2	3.5
Whitbread Plc	£	40.83	7,409	12.2	0.7	20.7	3.6
Minor International	Tb	24.70	98,838	13.6	1.8	21.0	3.4
Gourmet Master	TWD	242.00	34,151	11.6	(1.2)	27.6	4.8
President Chain Store	TWD	222.00	230,796	11.9	(1.5)	24.2	7.8
Coffee Focused Stocks excl CGF				**12.4**	**0.7**	**21.7**	**7.0**

Source: Bloomberg. Note: Data is at 23 April 2014, multiples based on 12-month forward estimates.

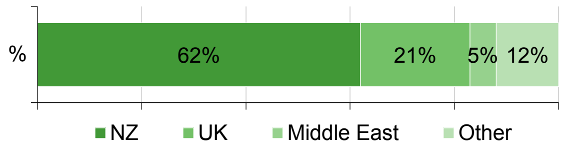
What is notable about these metrics is the almost complete lack of debt, with a debt/market cap ratio of 2.4% and a 7.1x price/book ratio for the peer group. This underscores the nature of the franchise mode, where companies have little in the way of fixed assets and high earnings relative to assets.

Compared to its peers CGF is trading at a premium on both EV/EBITDA and P/E metrics, reflecting its high near-term earnings growth compared to its more mature peers. An increase of 100 stores would expand CGF's footprint by 128%. However, the same increase in the number of stores would increase the footprint by 4% for Costa Coffee (WTB.LN) and by only 0.5% for Starbucks.

Exhibit 17: Financial summary

NZ$'000s	2012	2013	2014e	2015e	2016e
Year end March	IFRS	IFRS	IFRS	IFRS	IFRS
	March	March	March	March	March
PROFIT & LOSS					
Revenue	122	1,501	4,634	8,620	12,637
Cost of Sales	0	0	(1,769)	(2,983)	(4,177)
Gross Profit	122	1,501	2,865	5,638	8,460
EBITDA	99	1,240	(125)	1,263	2,356
Operating Profit (before amort. and except.)	99	1,240	(320)	1,015	2,104
Intangible Amortisation	0	0	0	0	0
Exceptionals	0	0	(1,521)	0	0
Other	0	0	0	0	0
Operating Profit	99	1,240	(1,841)	1,015	2,104
Net Interest	(691)	(78)	67	131	163
Profit Before Tax (norm)	(592)	1,162	(253)	1,146	2,267
Profit Before Tax (FRS 3)	(592)	1,162	(1,774)	1,146	2,267
Tax	0	0	559	(153)	(426)
Profit After Tax (norm)	(592)	1,162	306	993	1,840
Profit After Tax (FRS 3)	(592)	1,162	(1,215)	993	1,840
Average Number of Shares Outstanding (m)	25.7	26.9	63.3	259.3	259.4
EPS - normalised (c)	(2.30)	4.32	0.48	0.38	0.71
EPS - normalised and fully diluted (c)	(2.30)	4.32	0.48	0.38	0.71
EPS - IFRS (c)	(2.30)	4.32	(1.92)	0.38	0.71
Dividend per share (c)	0.0	0.0	0.00	0.00	0.00
Gross Margin (%)	100.0	100.0	61.8	65.4	66.9
EBITDA Margin (%)	81.1	82.6	-2.7	14.6	18.6
Operating Margin (before GW and except.) (%)	81.1	82.6	-6.9	11.8	16.6
BALANCE SHEET					
Fixed Assets	0	0	27,413	27,697	27,728
Intangible Assets	0	0	25,333	25,567	25,567
Tangible Assets	0	0	2,080	2,130	2,161
Investments	0	0	0	0	0
Current Assets	123	1,828	6,877	8,244	10,440
Stocks	0	0	210	293	386
Debtors	120	1,569	1,279	1,874	2,544
Cash	3	259	5,388	6,076	7,510
Other	0	0	0	0	0
Current Liabilities	(5,440)	(5,489)	(842)	(1,113)	(1,500)
Creditors	(183)	(286)	(842)	(1,113)	(1,500)
Short term borrowings	(5,257)	(5,203)	0	0	0
Long Term Liabilities	0	0	(1,355)	(968)	(581)
Long term borrowings	0	0	(581)	(581)	(581)
Other long term liabilities	0	0	(774)	(387)	0
Net Assets	(5,317)	(3,661)	32,093	33,860	36,087
CASH FLOW					
Operating Cash Flow	(20)	(163)	(1,010)	855	1,980
Net Interest	(98)	(78)	67	131	163
Tax (incl GST)	0	0	559	(153)	(426)
Capex (net of disposals)	0	(1,242)	(372)	(279)	(294)
Acquisitions/disposals	0	0	(2,654)	(621)	(400)
Financing	0	494	7,958	755	410
Dividends	0	0	0	0	0
Net Cash Flow	(118)	(989)	4,548	688	1,433
Opening net debt/(cash)	(5)	(3)	(259)	(4,807)	(5,495)
HP finance leases initiated	116	1,245	0	0	0
Net related party advances/(repayments)	0	0	0	0	0
Closing net debt/(cash)	(3)	(259)	(4,807)	(5,495)	(6,929)

Source: Company reports, Edison Investment Research

Contact details	Revenue by geography
Cooks Global Foods Level 5 3 City Road Auckland, New Zealand +64 9 307 0567 www.cooksglobalfoods.com	

CAGR metrics		Profitability metrics		Balance sheet metrics		Sensitivities evaluation	
EPS 2012-16e	N/A	ROCE 15e	3.2%	Gearing 15e	N/A	Litigation/regulatory	○
EPS 2014-16e	21.1%	Avg ROCE 2012-16e	N/A	Interest cover 15e	N/A	Pensions	○
EBITDA 2012-16e	121%	ROE 15e	N/A	CA/CL 15e	7.4	Currency	●
EBITDA 2014-16e	N/A	Gross margin 15e	65.4%	Stock days 15e	12.4	Stock overhang	○
Sales 2012-16e	219%	Operating margin 15e	11.8%	Debtor days 15e	79.4	Interest rates	○
Sales 2014-16e	65.1%	Gr mgn / Op mgn 15e	5.6x	Creditor days 15e	47.1	Oil/commodity prices	◖

Management team

Executive chairman: Keith Jackson

Keith Jackson has extensive experience in the management and governance of food and dairy based businesses. He was CEO of Tegel Foods for 16 years and has been involved in the dairy sector since the mid-1990s. He founded Cooks Food Group in 2008.

Executive director – business development: Stuart Deeks

Stuart founded the Esquires business in New Zealand and grew it from a single store to more than 50 stores to become New Zealand's largest coffee chain. Stuart was responsible for negotiating the master franchise agreements in the Middle East and China and played a key role in acquiring the UK and Irish master franchises.

Executive director – operations: Lewis Deeks

With Stuart Deeks, Lewis Deeks oversaw the expansion of Esquires in New Zealand and led the sale of this business to ASX-listed Retail Food Group in 2011. His focus is on operations and systems.

GM supply: Stuart McIntosh

Stuart has an extensive background in the fast moving consumer goods sector in manufacturing and operations roles, and in the branded coffee chain sector for a New Zealand based competitor. His focus is on the supply chain.

Principal shareholders	(%)
DSL Management Ltd (Stuart & Lewis Deeks)	56.1
Keith Jackson (Executive Chairman)	15.1
ADG Investments Ltd (Andrew Kerslake – Director)	13.1
Vendor shares subject to escrow	5.0

Companies named in this report

Whitbread Plc. (WHIT.LN), Starbucks Corporation {SBUX.US), Dunkin' Brands Group (DKDN.US), Retail Food Group (RFG.AX), Gourmet Master (2723.TT)