## Terms of Reference

The report is prepared in terms of addressing the financial situation of the enterprise known as "Pizza Express Plc". The analysis is based on the "Pizza Express Plc" annual report from 2002, requested February 10th, 2004 and handed in March 2nd, 2004.

## Introduction

The principle activity of Pizza Express Plc is operating restaurants, franchising restaurants and the wholesale and merchandising of food and beverages. Hence, the operating cycle should be relatively short. Pizza Express Plc may be identified as enjoying the fifth consecutive year of sales increase, which is a 214% growth since 1998. This is in accordance with the growth strategy proposed by the company. Similarly, one may identify the company's assets to have increased by 14.03% in 2002. One may recognize this capital expenditure to be financed primarily through net cash funds generated by operating activities. This could also have resulted in the company having a negative working capital. Moreover, the company raised £1.9 million in equity as a result of the conversion of deferred convertible non-voting shares and the exercise of share options. However, the company was still able to increase paid and proposed dividends per share for the year by 25%. One may also identify that Pizza Express Plc's relatively small amount of debt has remained changed by paying of the debts to the extend of 0.4. This may reflect a strategy to obtain a better credit rating in order to borrow at favourable rates in the future. One may also recognize that according to Porters 5 forces model (Appendix 2) each of the environmental forces affect industry profitability. A bonus scheme for employees is in place, however no bonuses were issued in 2002, which suggests good control over agency problems.

## Issues

- Growth
- Working capital
- Operating cycle
- Debt

### Growth

The group evidently has an aggressive growth strategy, which is explained in substantial detail in the report. The group has seen an increase in market share within the casual dining market as a whole, although this is not consistent with the forecasts of their particular industry. The group has been pro-active, and moves quickly with the changes in the environment and kept ahead of their competitors by holding down prices with only a slight increase in menu prices. Their pricing policy has given them a powerful competitive advantage, and their sales have continued to rise and their margins have increased. However, compared to one of its competitors, Enterprise Inns PLC, it appears to have less growth in sales (Appendix 6). The group has invested in increasing their fixed-assets, primarily in leaseholds and has forecasted that the mid-price dining market will be more consolidated in the future where only the strongest will survive. Their strategy seems to be to become one of the strongest by acquiring more instead of having the threat of being acquired. This is also shown by their policy to quickly lease out or reconstruct the less profitable units. Their aim is that profits generated by international franchising will cover initial losses in regions where they open group restaurants. Furthermore, retained earnings are reinvested into the growth of the group. The retention ratio increased to 71 %, which led to a sustainable rate of growth of 13.0 %. However, one may identify a decrease of 5% in ROE for the year 2002. The group believes in financing its growth by equity as opposed to debt. Issuing more shares is consistent with this strategy. However, one can identify that the growth in equity from £ 113.3 to £ 133.3 million is primarily a result of retained earnings, and is evidence of their policy to avoid debt as much as possible. They furthermore expect international expansion to accelerate over the coming years.

**Working Capital**

Working capital is the difference between permanent capital (Long-term debt and Stockholder Equity) less net fixed assets. Pizza Express Plc has a negative working capital of £15.5million (-12.2 million in 2001). However, the group may have had a positive net working capital of £21.4 million, generated by operating activities, not been invested in capital expenditure. Nevertheless, the group has negative working capital requirements of £9.4 million. This implies that the group has £6.1 million more working capital than required. Trade creditors may be seen as the cheapest form of short-term financing that is available to a company, because trade creditors don't charge interest. One could point out that the group haven't had any long term debt for past 2 years, due to that the interest expense for the group has declined substantially.

**Operating Cycle**

As Pizza Express Plc is in the restaurant industry, one may expect the operating cycle to be relatively short. The operating cycle is the recurring transition of a firm's working capital from cash to inventories to receivables and back to cash. One could identify the group to have an operating cycle of 35 days (Appendix 1). One may also identify that the group has a policy to pay creditors every 83 days. This implies that the group has a margin of 48 days. This could be seen to be consistent with the group having a negative net working capital. Therefore, one may assume that management has been effective in their operations. Moreover this could be the reason why management believe in having more short-term creditors than having long-term creditors.

**Debt**

In examining the books of Pizza Express Plc, one may identify that they are financing only with short- term capital rather than long-term capital. The debt to equity ratio is 41% in 2002 (45% in 2001), this implies that for every £1.00 the company owes its stockholders £0.41 in debt. "The debt – equity ratio indicates the establishment's ability to withstand adversity and meet its debt obligations." (Schmidgall and Damitio, 1996, p.444) However, various arguments exist on what level of debt a company should have. The main benefit of financing the company's assets through interest-bearing debt may be that interest payments are tax deductible and therefore lowers the cost of debt, hence “making more earnings available for investors” (Gitman, 2000, p.405) and retained earnings. Raising funds through equity may be more expensive than through debt as potential investors may find equity to be a higher risk investment than debt. However, increased debt may lead to an increased probability of bankruptcy if the business and financial risk is not determined correctly. In the case of Pizza Express Plc, if the eating out market declines, as has been the case recently, the business risk of not being able to cover operating cost increases, consequently affecting the financial risk of the company not being able to cover its financial obligations. However, since Pizza Express Plc has such a low level of debt, their financial risk is relatively low. This may imply that the company may be able to obtain new loans at relatively low interest rates. At present the company has a times interest earned ratio of 124 times (197.5 times in 2001), which means they are able to pay their interest 124 times out of their earnings before interest and tax. However, one should also caution that the earnings before interest and tax is not made up of only cash, and therefore does not give a completely true figure of how much interest could be covered. Nevertheless, the times interest earned ratio can be seen as being sufficiently high to assist the company in obtaining favourable rates of interest on debt and may facilitate the group in moving quickly in obtaining such debt. One may argue that, “the value of the firm is maximised when the cost of capital is minimized” (Gitman, 2000, p.408). Therefore, it may be beneficial for the company to increase debt levels, in order to maximise shareholder wealth.

## Recommendations

Within the restaurant sector one may identify a decrease in the casual eating out sector, which could indicate an increase in buyers bargaining power according to Porters five forces model (Appendix 3). However, Pizza Express Plc has increased their sales by 15.14 %, which may be seen to be consistent with the sales growth strategy over the last five years according to the trend analysis (Appendix 6). Nonetheless, this could be as a result of the large investment in fixed assets. Conversely, the return on owner's equity ratio indicates a decrease of 5%. By looking at the Du Pont analysis, giving a full picture of the financial structure, this decrease could be seen to be affected by the net profit margin which decreased by 2.6%, even though they have a good operating cycle and negative net working capital. In order to improve the net profit margin one may argue that the group could take on more long-term debt, thereby decreasing tax. The leveraging within Pizza Express Plc may be identified as not being optimised. Due to the low levels of debt and the high times interest earned ratio, the company may be able to obtain loans at favourable rates in order to take advantage of market opportunities.

| | | |
|---|---|---|
| Medicine | Continue growth but with further funding by debt as this may maximise shareholder wealth through economies of scale. | Be sensitive to changes in the environment and take advantage of market opportunities. |
| Time | Ongoing | Ongoing |
| Monetary Result | Increase debt within the margin of sustainable growth as to not disturb the financial structure. | Avoiding costs and losses incurred by not being sensitive to the environment. |
| By Whom | Management | All |

**2 March 2004**

| | | | |
|---|---|---|---|
| **Jeetendra Singh** | **Mukesh Chandak** | **Arvind Lakhothia** | **Ali Mustafa** |

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## Appendix

1. Ratios
2. DuPont Analysis
3. Porters Model of Forces Driving Industry Competition
4. Comparative and Common size analysis of Balance sheet and Income statement
5. Statement of Cash Flow
6. Trend Analysis of Turnover

## Ratio Analysis and calculation Analysis

| Ratio | Formula | 2002 | 2001 | Change | Explanation |
|---|---|---|---|---|---|
| Return on Assets | $\frac{\text{Net Income}}{\text{Total Assets}}$ | 0.14 | 0.16 | - 0.02 | The ratio determines the yield on the firms assets by relating net income to Total Assets. ROA is 14%, which means there is profit of 14 cents for every pound of total assets |
| Return on Equity | $\frac{\text{Net Income}}{\text{Total Equity}}$ | 0.19 | 0.24 | - 0.05 | A ratio relating earned income to the common stockholders investment. In year 2002 for every £1 of owners equity 19 pence was earned. |
| Operating Cycle | Accounts Receivable Turnover in Days + Inventory Turnover in Days | 35 days | N/A | N/A | The operating cycle represents the period of time elapsing between the acquisition of goods and the final cash realization resulting from sales and subsequent collections. |
| Debt to Equity | $\frac{\text{Total Liabilities}}{\text{Total Equity}}$ | 0.41 | 0.45 | - 0.04 | Compares operations net worth and indicates the operations ability to withstand adversity and meet its long-term obligations. It indicates for each £1 of owners net worth, the Pizza Express owed creditors £0.41. |
| Times Interest Earned | $\frac{\text{EBIT}}{\text{Interest Expense}}$ | 124 Times | 197.5 Times | -73.5 Times | A ratio that measures the firms ability to meet its interest payments from its annual operating earnings. The result of 124 times shows that Pizza Express could cover its interest expense by over fifteen times. |
| Sustainable Rate of Growth | ROE x (1-Dividend Payout Ratio) | 0.13 | N/A | N/A | Represents the rate at which a firm's sales can grow if it maintains it's present financial ratios and does not want to resort to the sale of new equity shares. |
| Working Capital Requirements | (Accounts Receivable + Inventories) – (Accounts Payable + Accruals) | -£9.4 | -£8.7 | | Working capital requirements is the amount of working capital a firm should have to run their operations. |

## DuPont system of analysis

DuPont system of analysis is the system used by management to dissect the firm's financial statements and to assess its financial condition. The system merges the income statement and balance sheet into two summary measures of profitability that are return on total assets (ROA) and return on equity (ROE).

DuPont formula could be argued as follow:

ROA = net profit margin x total asset turnover

Where the ROA is the product of the net profit margin and the total asset turnover. Later the formula is modified to:

ROE = ROA x FLM (financial leverage multiplier)

It relates the firm's return on total assets (ROA) to its return on equity (ROE) using the financial leverage multiplier (FLM). Where FLM is the ratio of the firm's total assets to stockholders equity.

The major advantage of this system is that it breaks the firms ROE into three parts: a profit-on-sales component (**net profit margin**), an efficiency-of-asset-use component (**total asset turnover**), and a use-of-leverage component (**FLM**).

In Pizza Express Plc., (2002) the net profit margin is 12%, whereas the total asset turnover is 1.14 times of sales to £1 of total assets contribution. According to the DuPont formula

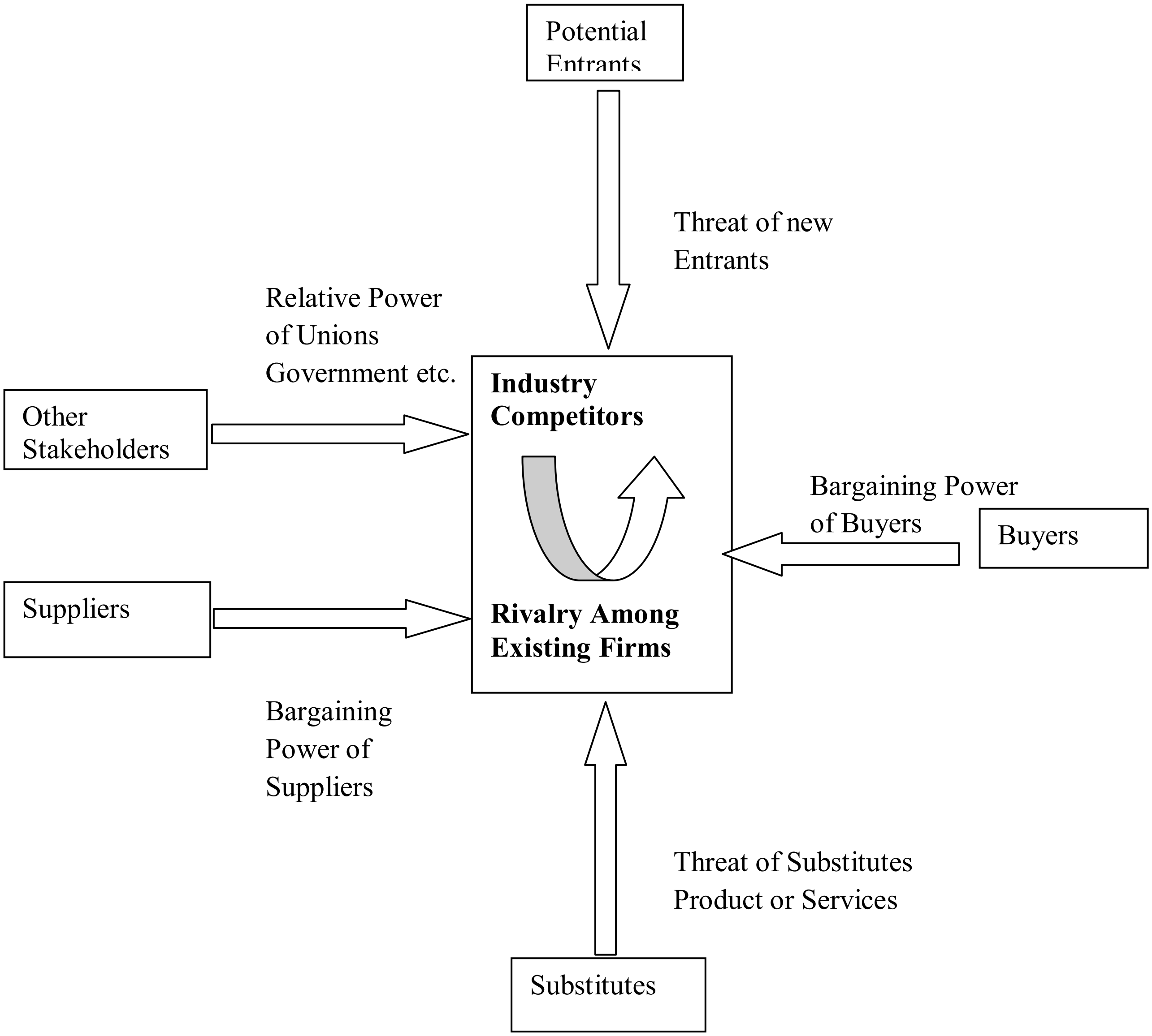
ROA = 12% x 1.14 = 14%

In order to evaluate that if ROE is greater than ROA, the formula is modified to

ROE = 14% x 1.41 = 20%

One can conclude that ROE is higher than the ROA, this indicates that the increased reflected in the ROE may be due to higher leverage from the shareholders fund compare to last year 1999. Or it can also point out that the company is reinvesting its profit into its assets, which also result to higher ROE. Higher ROE could also reflect in a way that employees, creditors, shareholders and etc contributed positively to the company. By analyzing and seeing the figures in Income statement and Balance sheet one could easily identify that the Assets are used very efficiently into the resources, which shows the good indication in running the business specially in fast food sector.

**Forces Driving Industry Competition**

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**Industry Analysis : Analyzing the Task Environment**

**Porters Model**

The collective strength of the forces determines the ultimate profit potential in the industry, where profit potential is measured in terms of long-run return on invested capital. In carefully scanning its industry, the company must asses the importance to its success of each of the six forces ;

**1. Threat of new entrants :**

The barriers of entry in the industry can not be considered high, with the exception of the large capital expenditure required to open a Pizza Express, but by expanding and gaining economies of scale the company is gaining an increasingly large market share. Product differentiation may increase their strength and thus barriers to entry.

**2. Rivalry among existing firms :**

There are numerous competing firms but the rate of industry growth is still high and the market is far from saturation. In comparison to the competitors thay seem to have a very strong market position.

**3. Threat of substitute products or services :**

It seems the group is efficient as monitoring its environment and acting proactively.

**4. Bargaining power of buyers :**

As the competition increases in the industry, the bargaining power of buyers should also increase because they can change to the competitor if their needs are not met.

**5. Bargaining power of suppliers:**

The bargaining power of suppliers should decrease as the size of the business increases, which is the case in this company.

**6. Relative power of other stakeholders :**

The relative power that governments, local communities, and other groups wield over industry activities. As the competitors of Pizza Express Plc are national as well as international, they are working under different local requirements. However, this does not seem to be percieved as a problem.

The stronger each of these forces, the more limited companies are in their ability to raise prices and earn greater profits.

A high force can be regarded as a threat because it is likely to reduce profits.
A low force can be viewed as an opportunity because it may allow the company to earn greater profits.
In the short run these forces can act as constraints on a company's activities.
In the long run, however, it may be possible for a company, through its choise of startegy, to change the strength of one or more of the forces to the company's advantage.

## Consolidated profit and loss account for the year ended 30 June 2002

| | | | | Common Size | Comparative | |
|---|---|---|---|---|---|---|
| | 2002 | 2001 | | | 2002 | 2001 |
| | £'m | £'m | £'m | | | |
| Turnover (including share of joint venture) | 213.8 | 185.9 | 27.9 | 15.01% | | |
| Less: Share of turnover of joint venture | -0.1 | -0.3 | 0.2 | -66.67% | | |
| **Group turnover-continuing operations** | 213.7 | 185.6 | 28.1 | 15.14% | 100% | 100% |
| Cost of sales | -156.4 | -129.8 | -26.6 | 20.49% | -73.19% | -69.94% |
| **Gross profit** | 57.3 | 55.8 | 1.5 | 2.69% | 26.81% | 30.06% |
| Distribution cost | -3.9 | -3.4 | -0.5 | 14.71% | -1.82% | -1.83% |
| Administration expenses | -15. 2 | -13. | -2.2 | 16.92% | -7.11% | -7 % |
| **Group operating profit-continuing operations** | 38.2 | 39.4 | -1.2 | -3.05% | 17.88% | 21.23% |
| Share of operating loss in joint venture | 0 | -0.2 | 0.2 | -100.00% | 0% | -0.11% |
| **Total operating profit: group and share of joint venture** | 38.2 | 39.2 | -1 | -2.55% | 17.88% | 21.12% |
| Profit/Loss on disposal of fixed assets | -0.1 | 0.3 | -1.3 | -433.33% | -0.47% | 0.16% |
| **Profit on ordinary activities before interest and taxation** | 37.2 | 39.5 | -2.3 | -5.82% | 17.41% | 21.28% |
| Net interest receivable/(payable) | 0.8 | 0.5 | 0.3 | 60 % | 0.37% | 0.27% |
| **Profit on ordinary activities before taxation** | 38 | 40 | -2 | -5 % | 17.78% | 21.55% |
| Taxation on profit on ordinary activities | -12.4 | -12.9 | 0.5 | -3.88% | -5.80% | -6.95% |
| **Profit on ordinary activities after taxation** | 25.6 | 27.1 | -1.5 | -5.54% | 11.98% | 14.60% |
| Dividends on equity shares | -7.5 | -6 | -1.5 | 25 % | -3.51% | -3.23% |
| **Retained profit for the financial year** | 18.1 | 21.1 | -3 | -14.22% | 8.47% | 11.37% |
| **Earnings per 10p ordinary share** | | | | | | |
| Basic | 35.8 | 38.8 | -3 | -7.73% | 16.75% | 20.91% |
| Dilute | 35.7 | 38.7 | -3 | -7.75% | 16.71% | 20.85% |

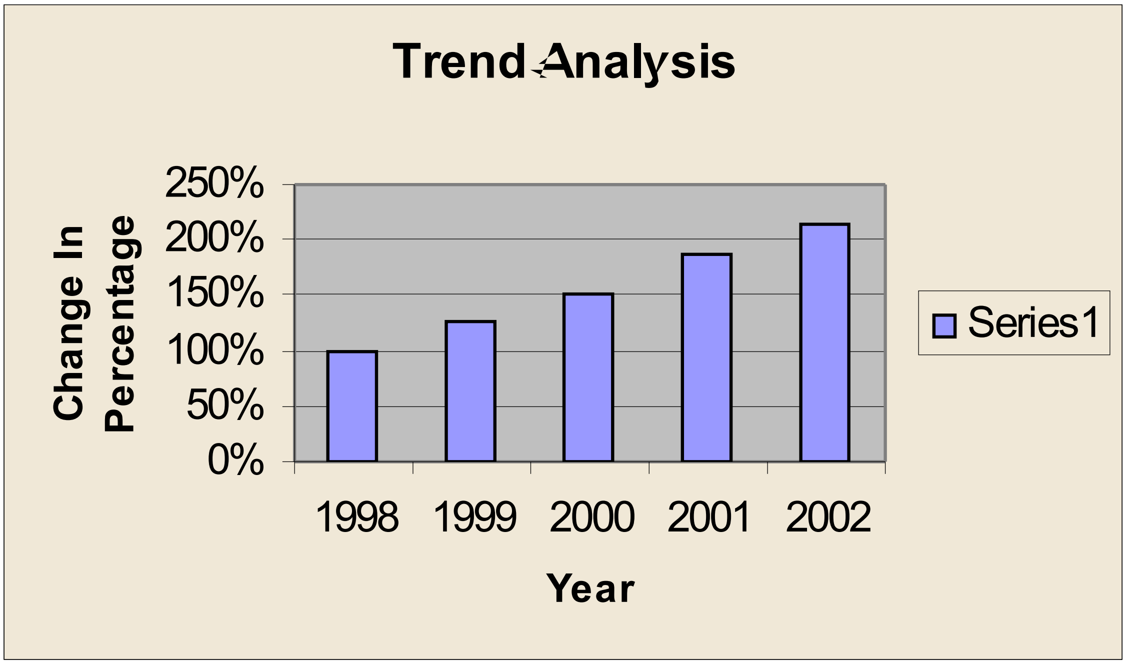
## Consolidated balance sheet for the year ended 30 June 2002

| | | | Common Size | | Comparative | |
|---|---|---|---|---|---|---|
| | 2002 | 2001 | | | 2002 | 2001 |
| | £'m | £'m | £'m | | | |
| **Fixed assets** | | | | | | |
| Tangible assets | 147 | 125.7 | 21.3 | 16.95% | 78.32% | 76.37% |
| Investments: | | | 0 | | 0.00% | 0.00% |
| In own share | 0.5 | | | | | |
| In subsidiary undertakings | | | 0 | | 0.00% | 0.00% |
| Other | 0.5 | 0.5 | 0 | | 0.27% | 0.30% |
| | 1 | 0.5 | 0.5 | | 0.53% | 0.30% |
| **Interest in joint venture:** | | | 0 | | 0.00% | 0.00% |
| Share of gross assets | 0.4 | 0.5 | -.01 | -20 % | 0.21% | 0.30% |
| | 148.8 | 125.5 | 23.3 | 18.57% | 79.28% | 76.25% |
| **Current assets** | | | | | | |
| Stocks | 8.4 | 7.5 | 0.9 | 12.00% | 4.48% | 4.56% |
| Debtors | 8.8 | 7.9 | 0.9 | 11.39% | 4.69% | 4.80% |
| Cash at bank and in hand | 20.8 | 23.7 | -2.9 | -12.24% | 11.08% | 14.40% |
| Asset held for resale | 0.9 | | | | 0.48% | |
| | 38.9 | 39.1 | -0.2 | -0.51% | 20.72% | 23.75% |
| **Total assets** | **187.7** | **164.6** | **23.1** | **14.03%** | **100.00%** | **100.00%** |
| **Creditors**: amounts falling due within one year | 40.1 | 38.2 | 1.9 | 4.97% | 21.36% | 23.21% |
| **Provision for liabilities and charges** | 14.3 | 13.1 | 1.2 | 9.16% | 7.62% | 7.96% |
| **Total Liabilities** | **54.4** | **51.3** | **3.1** | **6.04%** | **28.98%** | **31.17%** |
| **Capital and reserves** | | | | | | |
| Called up share capital | 7.3 | 7.2 | 0.1 | 1.39% | 3.89% | 4.37% |
| Share premium account | 61.9 | 60 | 1.9 | 3.17% | 32.98% | 36.45% |
| Profit and loss account | 64.1 | 46.1 | 18 | 39.05% | 34.15% | 28.01% |
| Shareholders' fund | 133.33 | 113.3 | 20 | 17.65% | 71.02% | 68.83% |
| (Including non-equity interest of £0.2m) | | | | | | |
| **Total Liabilities + Owners equity** | **187.7** | **164.6** | **23.1** | **14.03%** | **100.00%** | **100.00%** |

## Cash Flow Statement for the year ended 30 June 2002

| | 2002 | | 2001 | | Difference | |
|---|---|---|---|---|---|---|
| | £'m | £'m | £'m | £'m | £'m | % |
| **Reconciliation of operating profit to operating cash flows** | | | | | | |
| Group operating profit | 38.2 | | 39.4 | | -1.2 | -3.05% |
| Depreciation | 9.7 | | 8.2 | | 1.5 | 18.29% |
| Increase in stocks | -0.9 | | -0.4 | | -0.5 | 125.00% |
| (Increase)/Decrease in debtors | -1 | | -2.6 | | 1.6 | -61.54% |
| Increase in creditors and provisions | 0.9 | | 4.6 | | -3.7 | -80.43% |
| **Net cash inflow from operating activities** | | **46.9** | | **49.2** | **-2.3** | **-4.67%** |
| | | | | | | |
| **Investing Activities** | | | | | | |
| Purchase of tangible fixed assets | -32.7 | | -31.5 | | -1.2 | 3.81% |
| Sale of tangible fixed assets | 0.5 | | 1.2 | | -0.7 | -58.33% |
| Loan to joint venture | | | -0.8 | | 0.8 | -100.00% |
| Purchase of own shares | -0.5 | | | | | |
| Interest | 0.9 | | 0.5 | | 0.4 | 80.00% |
| Acquisition of subsidiary undertaking | -1.5 | | -0.2 | | -1.3 | 650.00% |
| Purchase of share in fixed assets | | | -0.2 | | | |
| Cash acquired | 0.1 | | | | 0.1 | |
| Purchase of investment in joint venture | | | -0.5 | | | |
| | | **-33.2** | | **-31.5** | **-1.7** | **5.40%** |
| | | | | | | |
| **Financing Activity** | | | | | | |
| Issue of share capital | 1.8 | | 13.2 | | -11.4 | -86.36% |
| Decrease in short term deposits with banks | 0.3 | | -2.9 | | 3.2 | -110.34% |
| Redemption of loan notes | -0.4 | | -0.6 | | 0.2 | -33.33% |
| Equity dividends paid | -6.4 | | -4.9 | | -1.5 | 30.61% |
| | | **-4.7** | | **4.8** | **-9.5** | **-197.92%** |
| | | **9** | | **15.3** | -6.3 | -41.18% |
| **Supplementary** | | | | | | |
| Taxation | | -11.6 | | -9.4 | -2.2 | 23.40% |
| **Decrease In cash** | | **-2.6** | | **13.1** | **-15.7** | **-119.85%** |

**Trend Analysis of Turnover**




| Year | £m | Change in percentage |
|---|---|---|
| 1998 | 99.6 | 100% |
| 1999 | 126.6 | 127% |
| 2000 | 150.1 | 151% |
| 2001 | 185.6 | 186% |
| 2002 | 213.7 | 214% |