8th April 2003

Buy (from ADD)

23p

Target Price: 32p

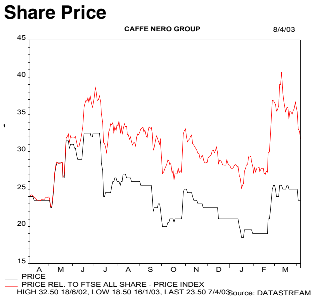
Caffè Nero

Upgrade to recommendation

Full of beans

Market Capitalisation	£17.0m
Shares in issue	68.1m
Code	CFN.L
Index	FTSE Fledgling
Net assets (05/02)	11.3p
Net debt (05/02)	£4.8m
Gearing	63%

Share Price



The consumers favoured Coffee Bar brand, Caffè Nero, has moved into pre-tax profitability ahead of time compared to our forecasts. This should herald a turning point in the share price performance of the business. Caffè Nero has a strong business model which will ultimately reward its shareholders, however, the stock has been held back over the past twelve months by negative publicity surrounding its sector peers. Also bid potential cannot be ignored in this consolidating segment of the food and drug retail sector reducing downside risk. BUY Caffè Nero.

Table 1	Sales (£m)	PBT (£m)	EPS (p)	Tax (%)	DPS (p)	Net cash (debt) £m	PE
2002 A	26.6	-1.18	-1.75	n/a	n/a	(4.8)	n/a
2003 F	39.8	0.31	0.46	n/a	n/a	(7.3)	50.0
2004 F	58.3	0.78	1.16	n/a	n/a	(10.9)	19.0

Recent Results. Caffè Nero recently reported pre-tax profits of £0.45m and EPS of 0.7p for the first half of the current financial year, making it the first branded coffee bar operator to make a profit before taxation in the UK. The results were supported by 70% sales growth and EBITDA margin expansion from 2.9% to 9.9%.

Greater scale. As the business has grown both organically and via the acquisition of Aroma from McDonalds, the company has accelerated its drive for the scale needed to become a serious player. Scale has resulted in Caffè Nero's central overhead being covered – thus profitability. Caffè Nero now operates from 113 outlets in the UK.

Growth opportunities. The company's strong brand and market position give it a number of interesting growth opportunities including provincial UK expansion, leveraging off the brand into other similar categories and the potential for Northern European expansion.

Banking facility. Caffè Nero recently arranged new banking facilities with the Bank of Scotland. Along with continued growth in cash profits (EBITDA) this gives the company the ability to continue to roll out new coffee bars or make small acquisitions.

Upgrade to forecasts. We have upgraded our forecasts for 2003 and 2004 using relatively conservative assumptions. For 2003 -£0.24m of PBT is upgraded to £0.3m or 0.46p of EPS. For 2004 we forecast £0.8m PBT or 1.2p of eps.

Outlook and valuation. With scale, a strong brand and adequate banking facilities in place, Caffè Nero has the ability to remain a clear top three player in this consolidating market. We forecast further growth in both operating and pre-tax profits and strong EPS growth. Sentiment towards coffee bar operators has held the shares back but ultimately this company has a strong brand and a model that will work. We recommend that open minded investors buy shares in Caffè Nero at this level. Target Price 32p.

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COMPANY SNAPSHOT

TYPE OF BUSINESS:

Caffè Nero is a chain of European style coffee houses in the UK, selling a range of espresso-based coffees and Italian deli food from its 113 coffee bars. It also owns the Aroma coffee bars acquired from McDonalds Corporation as well as having a 10.69% stake in Coffee Republic. Caffè Nero is the 3rd largest player in the UK with 8% market share of the branded coffee bar market. The company employs 920 staff in the UK.

STORE BASE:

Caffè Nero operates via 113 coffee bars including the Aroma sites acquired from McDonalds. This makes Caffè Nero the largest, independent UK coffee bar operator with sites in 38 UK towns and cities. The coffee bar base is split equally between London and the provinces.

SALES/EPS:

Chart 1 – EBITDA margins %

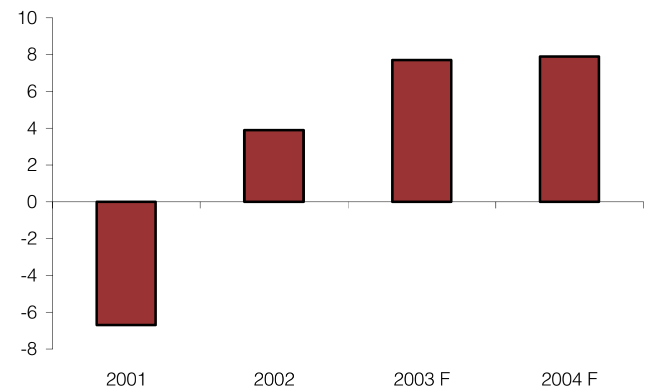
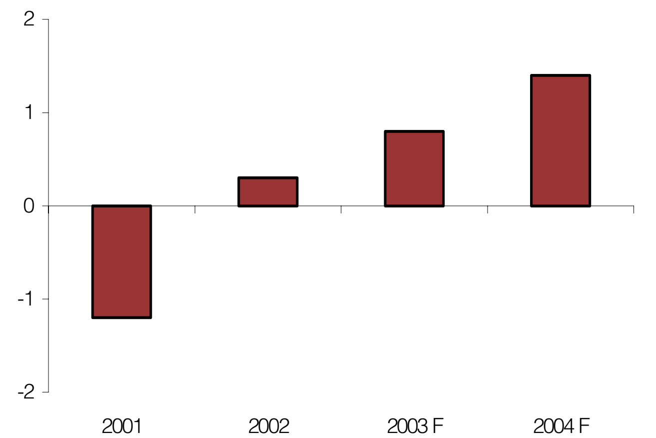


Chart 2 – PBT £m



FINANCIAL SUMMARY:

Table 2 - Year to June	Sales (£m)	PBT (£m)	Operating Margins (%)	EPS (p)	Net Debt £m
2002 A	26.6	-1.2	-3.0	-1.8	-4.8
2003 F	39.8	0.31	2.0	0.5	-7.3
2004 F	58.3	0.78	2.5	1.2	-10.9

Source: Numis Consumer Team

MANAGEMENT:

Chief Executive & Chairman – Dr. Gerry Ford; Managing Director - Christian Reeve; Finance Director – Ben Price

NEWSFLOW:

27th Feb 2003. Interim Results. Turnover up 70% to £19.2m, store profit up 85% to £3.46m, EBITDA up 486% to £1.9m, Pre-tax profit £450,000 and like for like sales of 3%

13 Dec 2002. Offer withdrawal. Withdrawal of 4.5p proposed offer for Coffee Republic for due diligence reasons.

29 Oct 2002. AGM Statement. Trading since the beginning of the current year, 1st June 2002 has continued to be solid, in line with market expectations. The former Aroma sites are performing well.

12th Sept 2002 – Final Results. Turnover £26.6m up 70%, Like for like sales up 2%, EBITDA increased to £1.1m, 108 locations at May year End. Cash balance of £4.1m at year-end.

9th Aug 2002 – Banking facilities. Financing arranged with banks giving Caffe Nero £10m cash available for share roll-out.

8th Aug 2002 – Increase in holding. Caffe Nero raised its stake in Coffee Republic to 10.69%

6th Aug 2002 – Increase in holding. Caffe Nero boosted its stake in Coffee Republic to 4.3%

17th June 2002 – Joint venture agreement. Caffe Nero entered into a joint with the Easy Internet Café chaine. This introduced the first Caffe Nero in a co-operative shared space.

2nd April 2002 – Acquisition. Caffe Nero completed the acquisition of Aroma from McDonalds Corporation for £2.15m, with a further payment of up to £640,000 being held in escrow for a period of 6 months whilst Aroma sites that they didn't wish to retain were sold.

Executive Summary

- The branded coffee bar market is still experiencing strong growth
- We forecast that branded operators will doubt their market share over the next six years
- Caffè Nero is the consumers favoured coffee bar brand according to Allegra Strategies
- Growth opportunities for Caffè Nero include;
    - Provincial UK expansion
    - Brand leverage into similar product categories
    - Northern European exposure
- The business has moved into pre-tax profitability ahead of time compared to market forecasts, making it the first branded coffee bar operator to make a PBT in the UK
- Nero is rapidly expanding its EBIT, EBITDA and Pre-tax margins
- Current trade is strong at Caffè Nero, 5.5% like for like sales
- The company is rapidly rolling out new space. Compound space growth is 25%. 50% of the Caffè Nero estate is outside of Central London
- Caffè Nero's market share has increased by 5% over the past three years
- More than adequate banking facilities are in place
- Bid potential cannot be ignored in this consolidating segment of the food and drug retail sector
- We have upgraded our forecasts and recommendations
- On 4.0x EV/EBITDA with strong earnings growth, we believe that Caffè Nero shares are undervalued
- BUY Caffè Nero, target price 32p

Key Points

We are positive on Caffè Nero for the following reasons:-

- Strong current trade
- Strong Brand
- Good business model

In this note we also discuss:-

- The UK coffee market
- Interim Results
- Valuation
- Outlook and Recommendation

The UK branded coffee bar market

Branded versus unbranded

The coffee bar market in this country is split between larger branded coffee groups and small independent coffee shops, often family owned. We believe that the UK branded coffee market is currently worth £470m.

Seattle Coffee Company

It all started in 1995 when the Seattle Coffee Company launched its first bar in the UK. Interestingly, the owners of the Seattle Coffee Company were until recently, the only people in the market to have made money from branded coffee in this country and this came with the sale of the business to Starbucks!

Strong growth in branded coffee

Growth in the UK coffee bar market has been exceptionally strong during the last 3 years as Starbucks has pushed hard to reach critical mass in this country. Branded coffee bars now account for just over 26% of the UK market by outlets. We forecast growth in this area to be 15-20% in 2003, much stronger than the independent segment.

Table 3 – Forecast growth in Branded Coffee Market

Year	Value	Branded growth	Branded estimated mkt share
2002 A	450m	20.00%	25%
2003 F	540m	20.00%	30%
2004 F	635m	17.50%	35%
2005 F	730m	15.00%	39%
2006 F	821m	12.50%	43%
2007 F	903m	10.00%	46%
2008 F	971m	7.50%	49%
2009 F	1,019m	5.00%	50%

Source: Numis Consumer Team

£2bn market by 2007

We forecast the branded coffee market to reach £1bn of sales by 2009. This equates to compound growth of 12%. At the same time we forecast the overall coffee market segment (out of the home) to grow in total by 11% to £2bn by 2007. We estimate that it is currently worth some £1.8bn.

The branded market is lead by the following companies:-

- Starbucks
- Costa Coffee
- Caffè Nero
- Coffee Republic
- Madisons
- AMT

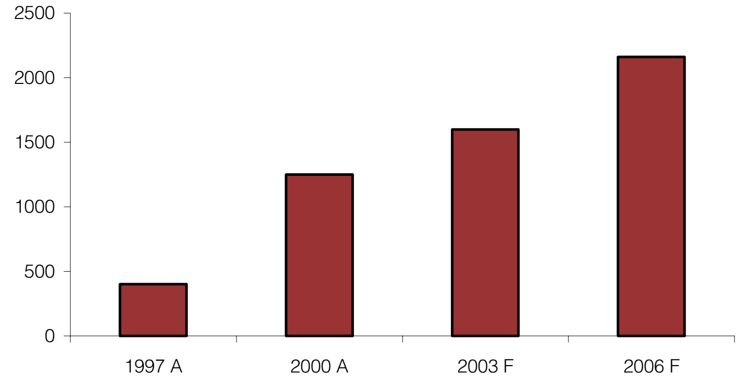
- Puccino's
- Ritazza
- Others

Sandwich bars – coffee sales

Dominant sandwich bars could arguably be seen as part of the same group although we have not included their sandwich/non coffee sales in our assumptions in table 3, they include;

- Pret A Manger
- EAT
- Benjys

Chart 3 – UK Market forecast – Units of branded coffee bars

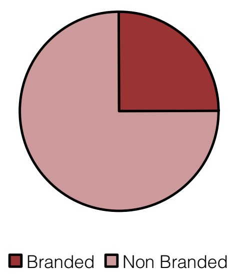


Source: Numis Consumer Team Estimates

Branded outlet growth

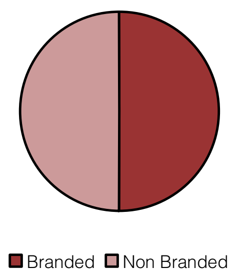
There are currently 1400 branded coffee bar outlets in the UK, we forecast this to rise to 2250 by 2006.

Chart 4: Branded / Non Branded 2002



Source: Numis Consumer Team

Chart 5: Branded /Non Branded 2009 F



Source: Numis Consumer Team

The pie charts above demonstrate our forecast change in the market (branded vs unbranded) over the next six years. We forecast the branded market to grow from 26% to 50% market share.

Market conditions

Near to saturation in London?

London is driven by convenience

The market has been difficult for weaker operators during the past year as some companies opened too much space leading to near saturation in certain key areas, especially Central London and the West End of London which still account for over 40% of all UK coffee bars by outlet. Even the mighty McDonalds Corporations flirtation with coffee bars ended in big losses; the Aroma sites were sold to Caffe Nero for 25% of the price paid by McDonalds. The market can of course continue to develop before saturation is a reality; indeed the market in Central London is driven by convenience therefore further growth in outlets is inevitable. We believe the market will end up with 2-3 distinct leading brands and a tail of lesser brands similar to the Food Retail and Restaurants sectors.

Provincial expansion for Caffè Nero

Evidence of a challenging environment lay in the like for like sales reported by some coffee bar businesses during 2002. Whilst we sympathise with the reasons sited by some coffee bar operators for last years slowdown i.e. a slow down in tourist numbers., we believe over-capacity or cannibalisation in London was the root of the problem. Too many coffee shops are battling for the same customers on the same high streets and consolidation will be the only way out for many players. However, some businesses like Caffè Nero have sensibly expanded their provincial offer to reduce Central London over-exposure. We believe Caffè Nero will succeed even though negative sentiment towards some coffee bar operators has held the shares back over the medium term. We believe this is all about to change.

Consolidation

Coffee Republic acquired GoodBean

Caffè Nero acquired Aroma

Starbucks acquired Seattle Coffee Company

We have already seen the early stages of consolidation in the UK Coffee bar market. Coffee Republic acquired GoodBean in 2001 and Caffè Nero acquired Aroma in April 2002. Starbucks had of course bought Seattle Coffee Company. Recently, speculation surrounding Coffee Republic intensified as firstly Caffè Nero raised its stake in the company to 10.69%, then Benjy's and Easy Group were quoted as being potential bidders. Caffè Nero has taken a step back from the table as far as acquiring Coffee Republic is concerned. We do not believe Caffe Nero would pay over 4p per share for Republic and given Bobby Hashemi has plans of his own regarding the development of that brand, it is unlikely that these businesses will trade under the same banner in the short-term. That is not to say that other operators would not be interested in Coffee Republic, but the likelihood is that Caffè Nero would prefer to negotiate to take a limited number of sites from whoever acquires Coffee Republic. There is logic in doing this as it tends to be a cheaper way of rolling out space compared to opening a brand new site which costs c £200,000 usually.

Caffè Nero is achieving pre-tax profitability

Starbucks, Costa and Caffè Nero

Caffè Nero is the only group currently achieving Pre-Tax profitability. Costa (owned by Whitbread group) makes an operating profit and profitability at Starbucks will follow, as and when it reduces the pace of roll-out. We believe the eventual outcome will be that three strong players will emerge, Starbucks, Costa and Caffè Nero and that by 2005 these will control 70% of the branded coffee bar market in the UK. Scale aside, the only other operators who look like surviving are the small convenience based coffee bars located in places such as train stations.

The competition for Caffè Nero

Costa, number 2 by market share

With 275 sites in the UK and £20m of wholesale business, Whitbread's Costa has 23% of the branded coffee market. Its offer is similar to Starbucks in that it is American-style coffee. Costa tends to operate from cheaper secondary sites and makes an operating profit. Costa's market share has fallen in branded coffee bar sales since the Millennium, however it has a strong parent in Whitbread and generates EBITDA. Therefore the usual alarm bells which might start to ring with an independent operator are void.

Starbucks, the market leader

Starbucks, the American coffee giant has been one of the success stories in consumer product roll-out history. Currently capitalised at $10.03bn, Starbucks has 26% market share in the UK with 345 bars. Based on the recent quarterly statement in the US, Starbucks has annualised operating profit of $480m, therefore it trades on an EV/EBIT of 21x, a substantial premium to Caffè Nero.

Coffee Republic brand could be squeezed out

Coffee Republic lost £7.5m in the past 12 months and is the number 4 player in the UK. We believe Republic will get squeezed out as a brand in the UK over the next few years. The company has received approaches and is unlikely to stay independent for long if it cannot push its way towards profitability quickly. The management are cutting the tail off the estate and looking to diversify further beyond coffee. Post the sale of some 13 sites to Starbucks, the exit from Waterstone's stores and the sale of two sites to Benjy's. Coffee Republic operates from 92 sites in the UK. This will be cut back to 70-75.

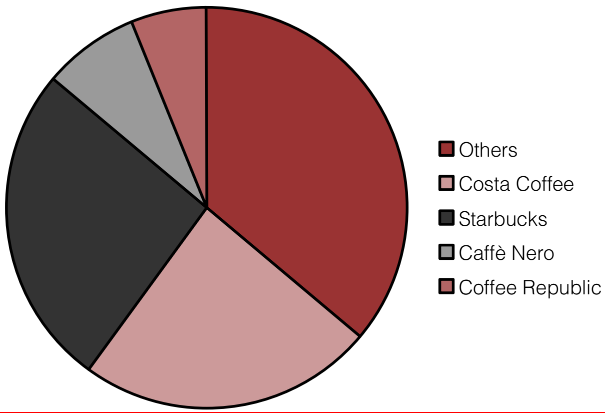
Table 4 – UK operators market share

Brand	No. of UK Stores	UK Est. Sales *	UK Market share F
Starbucks	345	£122m	26%
Costa	275	£113m †	23%
Caffe Nero	111	£38m	8%
Coffee Republic	82	£24m	6%
Others	n/a	£169m	36%

* indicates annualised
† includes £20m wholesale business

Source: Numis Consumer Team Estimates

Chart 6 – UK Branded Coffee Bar Market Share – 2003F

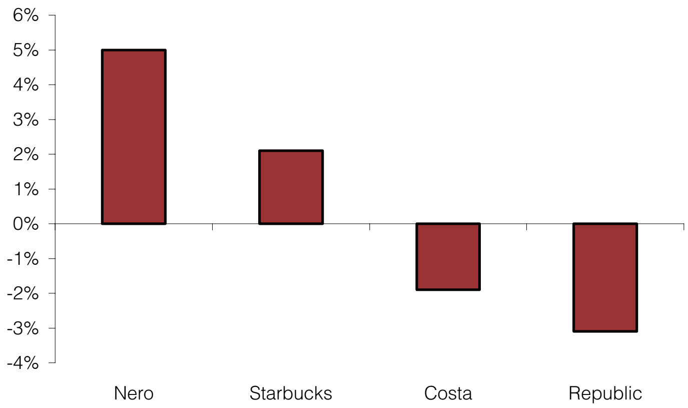


Source: Numis Consumer Team

The big will get bigger

The largest three operators Starbucks, Costa and Caffè Nero currently have 58% market share and continue to gain market share in both the branded and overall coffee market. In demonstrating the likelihood of those leading operators continuing to take market share, it is worth looking at other consumer areas like the Food Retail sector where the leading three operators have nearly 60% market share or over 85% of the single-shop market. This indicates that the leading coffee operators can still take considerable market share in Britain. We forecast the leading three operators will have 60% market share by mid 2004.

Chart 7– Market share winners and losers 2001-03



Source: Numis Consumer Team Estimates

Caffè Nero market share gains

Interestingly, as the chart above demonstrates, market share gains mirror much of the brand of choice and recognition analysis research by Allegra Strategies, where Nero and Starbucks also come out on top. Caffè Nero's market share is up 5% over two years, Starbucks is up 2%.

London versus the provinces

Provincial opportunities

The market in Central and West London now appears to be two-three years away from maximum profitable capacity in our view. New and improved coffee bars will always open at the expense of poorly sited and underperforming outlets, but the prospects for space growth in Central London and the West End now looks limited. The key to space growth for most operators lies outside of London. Within the provincial market, the ratio of coffee bars per capita is close to 1:100,000, which is very low, the market could support a ratio of 1:40,000 in our view. This shows that expansion outside of London is still in its early stages. Indeed most of the branded players are concentrating their efforts on finding sites in the provinces. One of the reasons that the London market has seen so much increased capacity is that more people have become used to branded coffee bar purchases as a lifestyle choice and because most customers cite convenience as a core reason for using a branded coffee bar in London. Therefore many operators are chasing the same customers in smaller conurbations thus cannibalising each other's sales.

Can You make money in Coffee?

Yes, money can be made in coffee

Up until recently, many followers of the segment would have said NO. We have believed for some time that the Caffè Nero and Starbucks models *could* work in this country but we are only now in a position to say definitively, that **these operators can make money in coffee in the UK.**

The key to profitability

We believe the key to profitability in the sector to be as follows:-

- Economies of scale
- Sector Consolidation
- Improve range / broaden offer
- Closing underperforming sites where possible
- Reducing other overheads.

Branding opportunities 'drinking in the home' 'coffee stations' etc

For the survivors of the competitive Branded coffee market, we believe there will be significant opportunities to leverage off the brands that have been created. We believe branding opportunities will come via the 'drink in the home' market of coffee as well as other routes to market. Nescafé for example has had convenience stores setting up vending facilities (Nescafé.go), Nescafé say that over 40% of coffee drinkers drink specialty coffee outside of the home. Coffee Nation has 124 coffee stations in the UK selling 300 - 400 cups per day. Ritazza also has coffee stations in places like motorway service stations. We see no reason why these initiatives cannot be capitalized upon by Caffè Nero, Starbucks or Costa Coffee for example.

The Caffè Nero background and Strategy

Nero started in 1997

Caffè Nero started with 5 London based outlets in 1997 and now has 113 bars nationally. Caffè Nero's strategy is to open enough space in the UK to become highly profitable and be a clear top 3 player in the market. The company currently occupies the number 3 spot in terms of outlets and coffee sales but it is a long way behind Starbucks and Whitbreads' Costa Coffee as chart 6 demonstrated. Therefore it has a lot of scope to grow its market share.

Table 5 – Caffè Nero business model

Stores	300
Sales	£100 - 120m
Store Profit	20%
Central Overheads	5.5%
EBITDA	14.5%
EBITDA Quantum	£14.5 - 17.4m
Depreciation	5.0%
EBIT	9.5%
EBIT Quantum	£9.5 - 11.4m

Source: Numis Consumer Team Estimates

£10m EBIT Target in the UK

The Caffè Nero business model above demonstrates the companies plan to deliver in the region of £10m of EBIT or a 9.5% margin, from 300 stores in the UK. It is worth comparing the model above to where we currently sit.

Table 6 – Caffè Nero current position

	Model	H1 2002/2003 A	2005F	2008F
Stores	300	**111**	180	270
Sales	£100-120m	**£38.4m**	£54.0m	£84.0m
Store Profit	20%	**18%**	19%	19.8%
Overheads	5.5%	**8.6%**	7.1%	5.8%
EBITDA	14.5%	**9.4%**	11.7%	14.0%
EBITDA Quantum	£14.5-17.4m	**£3.5m**	£6.3m	£11.8m
Depreciation	5.0%	**6.0%**	5.6%	5.2%
EBIT	9.5%	**3.8%**	6.1%	9.0%
EBIT Quantum	£9.5-11.4m	**£1.5m**	£3.3m	£7.6m

* indicates annualised

Source: Numis Consumer Team Estimates

The model developing

In the table above, we have made relatively conservative assumptions as to how the Caffè Nero model will develop over the next 5 - 6 years. The table demonstrates the gearing effect of opening stores off the infrastructure that is in place. The model set out by Caffè Nero for the UK will allow growth for the next 6 years in our view.

Quality Italian coffee at a small discount to the competition

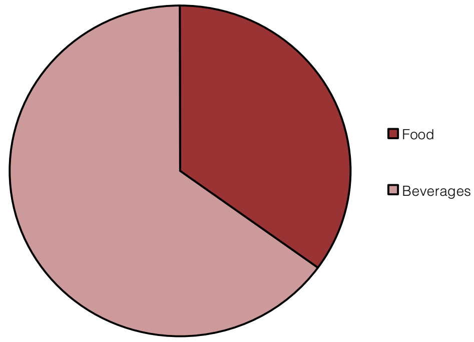
Caffè Nero's core coffee product is based on an Italian style coffee. This has given Caffè Nero a point of difference to the likes of Starbucks and other US style coffee houses. Standard coffee products at Caffè Nero are generally priced in-line to slightly cheaper than other operators.

The importance of food

35% of sales = food

The key to enhanced profitability may lie in coffee bars non-coffee products ie. food. Branded coffee bars like Caffè Nero are increasing their range of foods from sandwiches, cakes, muffins and crisps etc. Caffè Nero has a larger non-coffee offer than their closest competitors with 35% of total sales being driven from food. It will be important that Caffè Nero continue to further develop the quality non-coffee offer to improve profitability. We believe that the food offer is stronger at Caffè Nero, add the elegant décor and surroundings and it should come as no surprise that Nero is beating the competition in terms of like for like sales and pre-tax profitability.

Chart 8 – Beverages: Food Sales Split at Caffè Nero



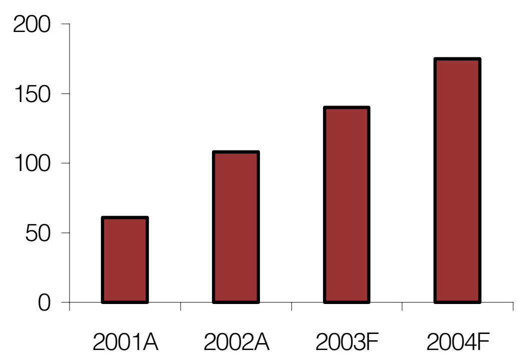
Source: Caffè Nero/Numis Consumer Team

Roll Out

25% space growth

Caffè Nero currently operate 113 coffee bars in the UK and will continue to roll out an average of 3 coffee bars per month. This rapid expansion equates to 25% compound growth per year over the next 3 years. To date, the company has stayed on target with its space growth promises. Caffè Nero believe that they can take advantage of both lower rents and industry consolidation in pressing ahead with its roll-out.

Chart 9 – Caffè Nero Store Numbers



Source: Caffè Nero/ Numis Consumer Team

Caffè Nero roll out has become self-financing

We can calculate the businesses ability to role out space by making some simple assumptions. The company had net debt of £6.0m (at the end of the first half) with facilities to lend a further £5.0m. If the company was to role out space without raising its debt levels (which admittedly is unlikely given the opportunities for role out at reasonable rents currently on offer) it could self-finance 18 sites per annum based on our assumption for full year EBITDA of £3.5m. This number is of course conservative as EBITDA available for self financing will rise. If the company plan to open 3 sites per month then we calculate that it will use £3.6m of its banking facilities this year. The table below demonstrates that Caffè Nero is now able to self-fund its roll-out. Gearing should fall rapidly from 2005 when it should have 195 stores. We forecast debt at that time will be c£11m.

Table 7 – Caffè Nero self-finance

	EBITDA (£)	Cost of Site (£)	EBITDA Fundable sites
2003 F	5.0m	0.2m	18
2004 F	5.5m	0.2m	25
2005 F	7.3m	0.2m	36
2006 F	8.5m	0.2m	33+

Source: Numis Consumer Food

Once a site has opened, the company does not need to spend excessive amounts of maintenance capex like a high street bar operator. The company spends c£20,000 two and a half years after opening, we would forecast similar levels of expenditure every two – three years per site.

Cash consumption and Banking facilities

Roll-out funding not an issue

For current and potential investors of Caffè Nero and other players in the UK coffee bar market, cash consumption has been a major issue. However, this feature is to be expected with high space growth. As the company remains determined to continue to open new space, especially in the provinces, we welcome the recent announcement that they re-negotiated their banking facilities with the Bank of Scotland. This should ensure solid space growth. The company negotiated £7.0m of new bank financing giving it £11.1m including year-end cash balances to acquire or roll-out space. As a result of renegotiation, the company reduced its interest rates.

Aroma acquisition

Aroma acquisition

In March 2002, Caffè Nero acquired the Aroma sites from McDonalds Corporation. 19 of the 29 sites acquired were immediately re-branded/converted to the Caffè Nero brand while the remaining sites were reviewed. Outside London, the acquisition did bring some very useful and desirable space in Manchester, Portsmouth, Reading, Woking and Ashford. The converted Aroma sites continue to see strong uplifts in sales of some 10% compared to pre-acquisition sales levels – this uplift has slowed a little but is still impressive. The acquisition of sites like this can be a cheaper way of rolling out new space as the table below indicates.

Table 8 – Aroma acquisition model

Acquisition route - Aroma example *	
No. of sites	29
Acquisition cost	£2.3m
Cost per site	£0.08m
Conversion cost per site	£0.06m
Total Cost per site	£0.14m
To open new site	£0.20m
Saving per site	**£0.06m**

* = value Aroma brand at 0

Source: Numis Consumer Team Estimates/ CaffèNero

Supply chain improvements

Number of suppliers reduced

The company switched suppliers during 2002 to compliment its own store portfolio to those suppliers with truly national reach. The number of suppliers has also reduced to improve buying strength as the supply chain has been centralised. However, the regional, operational structure of the company has needed strengthening to support roll-out.

Staff retention programme

Staff retention improvements

Coffee bar operators like many retailers and bar operators have struggled to retain staff as pay is relatively low and very few people want to make selling cups of coffee their life ambition. Whilst this will always be a difficult area, the retention of store managers is an area were operators can improve, this will lead to greater stability on a store basis and improve morale below store management level as staff can see benefits in the promotional structure within the group. Caffè Nero launched a programme to improve staff retention in 2002 which has certainly started to show some benefits. Store managers now stay with Caffè Nero on average 30% longer than previous.

Growth opportunities

In addition to continuing to progress their business model as planned over the medium-long term, on a short to medium term basis, the company has 3 potential growth opportunities:-

- The UK provinces
- Leverage off branding opportunities
- European expansion

50% of Nero sites outside of Central London

The UK provinces

As we have already discussed, expansion into other towns and cities which are underrepresented in terms of coffee bars is key to Caffè Nero's expansion plans. The company now operate in 38 towns and cities outside of Central London. Caffè Nero moved into 17 of these towns and cities in the past 18 months. 50% of the estate is now outside Central London. The process of expanding its provincial UK base will continue, indeed over the next two – three months the company has outlets opening in 3 new towns. In total, the company will open 10 sites in this period.

Table 9 – Regional Store Breakdown

STORE	REGION
Ashford, Kent	South East
Bath	South West
Birmingham, The Pavillions Shopping Centre	Midlands
Birmingham, Corporation Street	Midlands
Brighton	South
Bristol	South West
Bromley	South East
Cambridge	South East
Canterbury, Kent	South East
Chester	North West
Chichester	South
Durham	North East
Glasgow	Scotland
Guildford	South East
Harrogate	Yorkshire
Leeds	Yorkshire
Leicester, Haymarket Shopping Centre	Midlands
Leicester, Market Street	Midlands
Liverpool, Whitechapel	North West
Liverpool, Castle Street	North West
Livingstone, McArthurGlen Outlet Village	Scotland
	Greater London
Balham	Greater London
Chiswick (192 Chiswick High Street)	Greater London
Chiswick (386 Chiswick High Street)	Greater London
Hammersmith	Greater London
Harrow	Greater London

Heathrow (Terminal 1)	Greater London
Heathrow (Terminal 2)	Greater London
Heathrow (terminal 1 Land side)	Greater London
Kingston	Greater London
Putney	Greater London
Sheen	Greater London
Aldwych	Central London
Bedford Street	Central London
Bishopsgate	Central London
Brewer Street	Central London
Camden	Central London
Charlotte Street	Central London
Clapham (Junction)	Central London
Clapham (High Street)	Central London
Covent Garden	Central London
Cranbourn Street	Central London
Curzon Street	Central London
Eastcheap	Central London
Edgware Road	Central London
Frith Street	Central London
Fulham Road	Central London
Hampstead	Central London
Holburn	Central London
Kensington	Central London
Kensington High Street	Central London
Kings Road (115 Kings Road)	Central London
Kings Road (201 Kings Road)	Central London
Kingsway	Central London
Lancaster Place	Central London
Leadenhall	Central London
Long Acre	Central London
Newgate Street	Central London
Nottinghill	Central London
Oxford Street	Central London
Paddibgton	Central London
Picadilly (70 Picadilly)	Central London
Picadilly (26-28 Picadilly)	Central London
Portcullis House	Central London
Portabello	Central London
Regent Street (225 Regent Street)	Central London
Regent Street (273 Regent Street)	Central London
Seven Dials	Central London
Shoe Lane	Central London
South Kensington	Central London
Southampton	Central London
Strand	Central London
Tottenham Court Road	Central London
Westbourne Grove	Central London
Wilcox Place	Central London
Winchester House	Central London
Wormwood Street	Central London
Manchester (Cross street)	North West
Manchester (Deansgate)	North West
Manchester (Market Street)	North West
Manchester (The Triangle)	North West
Manchester (Trafford Centre)	North West
Northampton	South
Norwich	East
Nottingham	Midlands
Oxford	South
Peterborough	South
Portsmouth	South
Reading	South East
Tunbridge Wells	South East
Windsor	South
Woking	South East
Worthing	West Sussex
York (Davygate)	Yorkshire
York (MacArthurGlen Designer Outlet)	Yorkshire

Source: Numis Consumer Team/Caffè Nero

Leveraging off branding opportunities

We believe that the companies which have developed the strong coffee bar brands in the UK will have an opportunity to leverage into areas such as coffee in the home, convenience coffee stations, retail opportunities etc Potentially some well-located coffee bars could also apply for late licences or on-trade liquor licences.

European expansion

European potential

We would expect companies like Caffè Nero to start to roll-out coffee bars in Northern Europe over the next few years, again leveraging off central cost and achieving buying benefits, although key raw materials like milk, coffee beans and packaging are unlikely to be subject to major buying benefits. Starbucks already trade in Northern European countries such as : -

- Germany
- Holland
- Denmark
- Sweden
- Norway

Could be markets which are ripe for branded coffee bar operators.

Risks

Coffee risks

Given the underperformance of stocks like Coffee Republic, it is worth assessing the risks inherent in the coffee bar segment of the Food & Drug Retail sector. They are:-

- Effects of tourism – particularly in London
  Although Caffè Nero has diversified into the provinces
- Expensive locations
  Nero are currently finding rental pressure is actually reducing
- Other *similar* operators like Pret a Manger, Benjy's and EAT taking market share.
  Caffè Nero has 35% of sales coming from food and a well received brand
- Restaurants and pubs using coffee to attract customers in quiet times
- High street slowdown

Recent Half Year Results Statement

£0.45m PBT

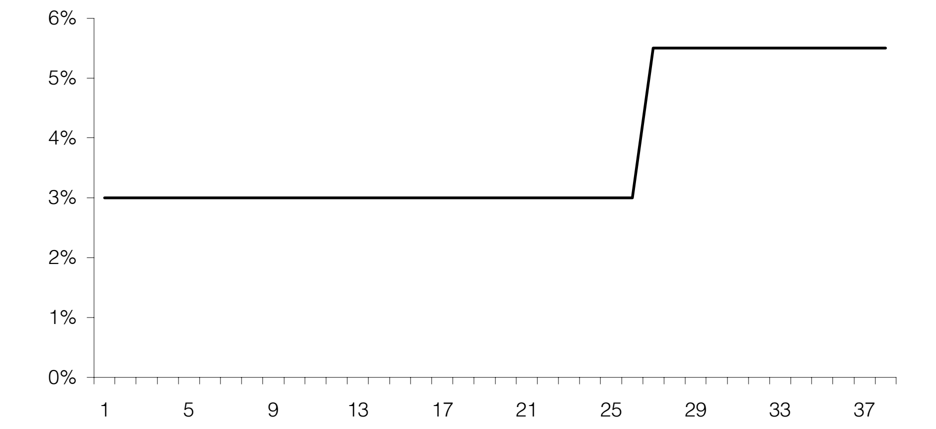
The recent full year results statement for the 26 weeks ended 30 November 2002 saw Caffè Nero become **the first branded coffee bar operator to achieve pre-tax profitability in the UK.** Pre-tax profits before amortisation and exceptionals came in at £0.45m.

3% like for like sales growth

Sales

Total sales were up 70% to £19.2m. Within this sales growth, 67% was achieved by space growth leaving 3% like for like sales growth. This like for like sales growth was volume driven.

Chart 10 – LFL sales growth



Source: Caffè Nero/Numis Consumer Team

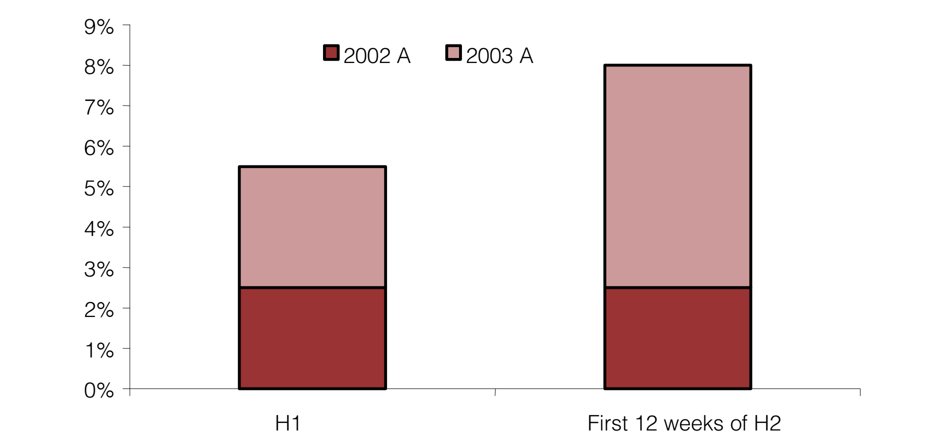
Sales acceleration

Like for like sales in current trade accelerated to 5.5%. The chart above demonstrates the recent acceleration. Like for like sales outside of Central London have been rising by high single digits as opposed to London where like for likes have been low single digits. The stores used in the current LFL sales figures are still skewed towards Central London, therefore, given growth is coming from the provinces, we believe that as these stores join the same store sample, they should support the like for like contribution.

2 year LFL sales growth

We believe that like for like sales should be studied on a two year basis as this demonstrates whether positive improvements in same store sales increases are genuine or just improvements on periods of weak comparative trade in a previous year. As chart 11 demonstrates, Caffè Nero's two year like for like sales performance in recent months has been based on genuine organic growth and not rebounding growth on soft comparisons.

Chart 11 – 2 year LFL performance



Source: Caffè Nero/Numis Consumer Team

Table 10- Caffè Nero Half year sales analysis

	Sales	Growth
H1 01/02	£11.3m	x%
H2 01/02	£15.2m	35%
H1 02/03	£19.2m	26%

Source Caffè Nero

Table 10 above demonstrates the solid half year on half year growth being demonstrated by Caffè Nero.

Table 11 – Caffè Nero Full year sales analysis

	Interim Stage	Y/Y Growth	Full year stage	Y/Y Growth
FY 2001	£6.7m	n/a	£15.6m	132%
FY 2002	£11.3m	68%	£26.6m	70%
FY 2003 F	£19.2m	70%	£39.7m	50%

Source: Caffè Nero

Year on year growth is impressive. Early on in the company's development this was necessary in order to cover fixed costs. The company has reached a point were sales are covering fixed costs, the all important race for scale is being won.

Margin Analysis

Gross Margin

Stable gross margins

The gross margin environment is relatively stable across the industry, although scale is leading to some modest gross margin improvements for Caffè Nero. Both beverage and food product margins are high, therefore, despite Caffè Nero's food contribution being higher than its competitors, its margin profile at a product level is similar to its competitors. However, coffee margins are higher than food margins.

Store Contribution

Strong store contribution growth

The company quote a store profit in statements based on Gross Profit minus (Staff costs and Lease costs) or EBITDA plus non-store related operating costs. Store profits rose 85% to £3.46m during H1. The table below demonstrates the half on half year growth in store contribution at Caffè Nero;

Table 12 – Store profit analysis

	Profit	Growth
H1 01/02	£1.9m	-
H2 01/02	£2.2m	16%
H1 02/03	£3.5m	59%*
* accelerates due to Aroma conversions and benefits		

Source: Caffè Nero

Interestingly, we can see recent half on half store profits have risen 59% vs 16%. This is mainly due to the benefits from the acquisition of Aroma, however, scale is leading to an improved underlying picture for store contributions.

EBITDA Margins

Improving EBITDA margins

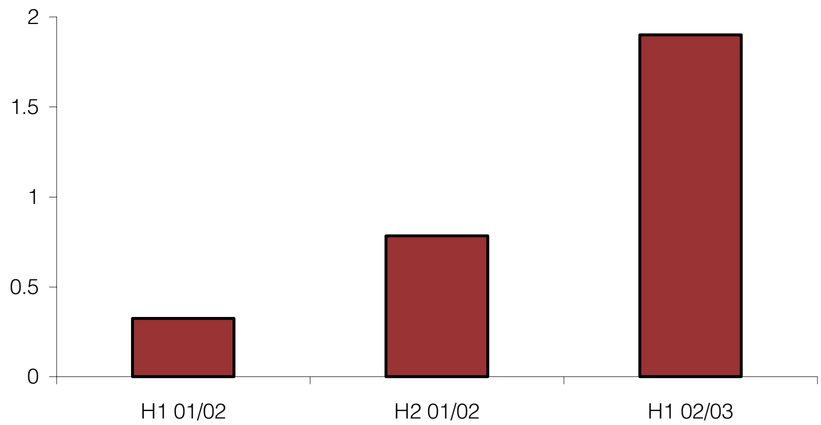
EBITDA margins rose by 700 bps from 2.9% to 9.9% with EBITDA coming in at £1.9m. This allows Caffè Nero to increasingly fund a substantial part of its roll-out form cash profits. The company will still require increased borrowings to fund the role out opportunities available to it.

Table 13 – Caffè Nero EBITDA margin progression

Year	EBITDA margins
2001	-6.7
2002	3.9
2003 F	7.7
2004 F	7.9

Source: Numis Consumer Team Estimates/Caffè Nero

Chart 12 – EBITDA (£)



Source:Caffè Nero/Numis Consumer Team

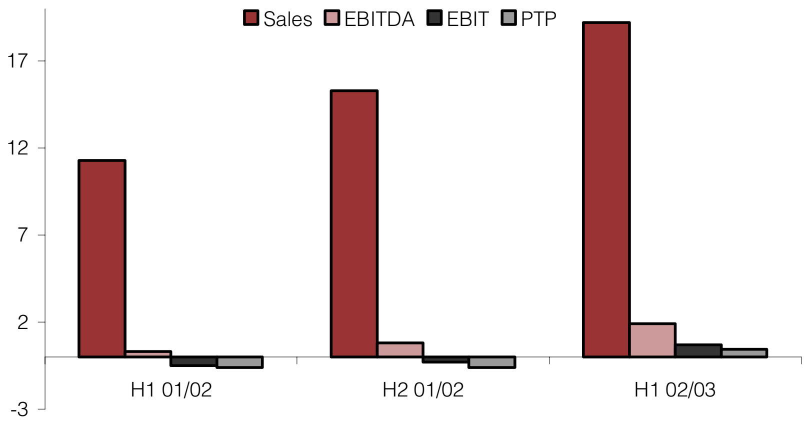
This graph demonstrates the cashflow profit coming through which will underpin Caffè Nero's store rollout programme going forward.

Pre-tax profitability – a feature at Caffè Nero

PBT Margins

Pre-tax profitability is now a feature at Caffè Nero, Nero has become the first coffee bar operator to make bottom line profits in the UK. Pre-tax profits before amortisation of goodwill and exceptionals came in at £450,000 in H1, we had been looking for a loss of £250,000 at this stage. EPS came in at 0.7p. As a growth/role-out story, the company does not pay dividends nor do we expect to see any dividend distribution in the next 2 years.

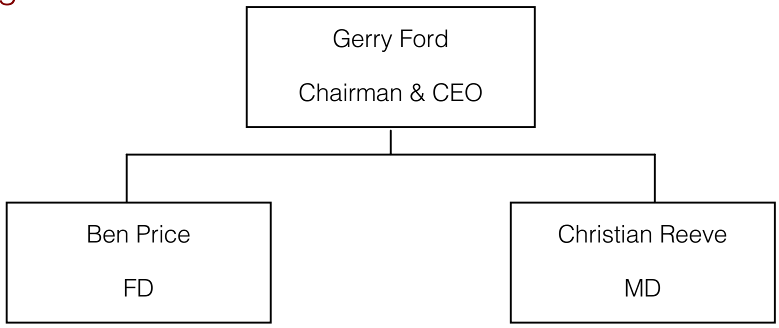
Chart 13 – Sales, EBITDA, EBIT, PBT progression



Source: Caffè Nero/Numis Consumer Team

Chart 13 above demonstrates how scale has reached a critical level during the past 6 months, leading to EBIT and Pre-tax profits moving into positive territory.

Management



Strong and stable management

Led by Gerry Ford, we are impressed with the managements performance to date. The company have set targets and stuck to those targets in order to develop critical mass. The management have met all targets for roll-out and margins to date. We believe that stable management has been advantageous to Caffè Nero. Gerry Ford and Christian Reeve have been with the business from the outset, this contrasts with other companies in the coffee sector where management has changed on two or three occasions to date. The management team at Caffè Nero is very entrepreneurial.

Events Calendar

May 2003	Financial Year-end
August 2003	Final Results for FY 2002/2003
August 2003	AGM
November 2003	Half year-end
January 2004	Christmas Trading Statement
February 2004	Interim Results for FY 2003/2004

We next hear from the company in May for a pre year-end briefing. The company report final results for the financial year 2002/2003 in August.

We are forecasting the following:-

- £39m sales (representing growth of 50%)
- Store contributions to have improved
- Operating margins to have continued to improve,
- At a pre-tax level the business should show profits of £0.31m
- Like for like sales of 3% for the year
- Store base expanded to 125 stores.

Valuation and Recommendation

Judge on objectives met, brand value and potential to grow profits

On conventional terms, Caffè Nero has been difficult to value previously as it made little or no profit on either an EBIT or pre-tax basis. Conventional valuation techniques will become increasingly relevant as profitability grows. However, we must look at the company's record in terms of meeting its stated objectives and assess the company's cash facilities, roll-out plans, brand value and likelihood of growing profitability. In terms of cash and roll-out plans, we have already demonstrated that we are comfortable with the companies roll-out plans and funding over the next 3-5 years.

We now turn our attention to our key valuation measure, value creation as well as EV/EBITDA, EV/Sales and P/E. The table below summarises some key valuation metrics.

Table 14 - Valuation in the Food & Drug Retail sector

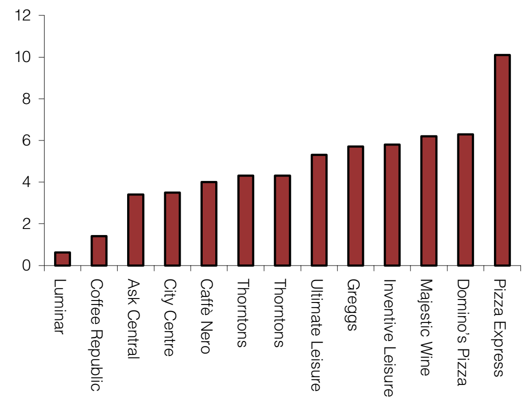
Valuations in the Food & Drug Retail sector	2003 EV/EBITDA	2004 EV/EBITDA	2003 P/E	2004 P/E
Ask Central	3.9	3.4	9.3	8.2
Caffè Nero	**5.5**	**4.0**	**29.4**	**15.2**
City Centre	3.7	3.5	9.1	8.5
Coffee Republic	1.5	1.4	Neg	Neg
Domino's Pizza	8.5	6.3	13.5	10.1
Greggs	6.0	5.7	13.1	12.2
Inventive Leisure	6.2	5.8	8.7	6.9
Luminar	3.8	3.5	5.1	4.9
Majestic Wine	6.7	6.2	12.7	11.9
Pizza Express	10.5	10.1	13.4	13.0
Thorntons	4.4	4.3	12.9	11.7
Ultimate Leisure	6.8	5.3	6.6	5.7

Source: Numis Consumer Team Estimates

4.0x EV/EBITDA

We can see that 2004 EV/EBITDA for Caffè Nero is 4.0x, we believe that this is anomalous given the growth prospects, especially compared to other similar stocks in the consumer area. This is demonstrated in chart 14.

Chart 14 – Sector 2004 EV/EBITDA



Source: Numis Consumer Team Estimates

Table 15 - Valuation in the Food & Drug Retail sector

Valuations in the Food & Drug Retail sector	2003 EV/EBITDA	2003 EV/Sales	2003 P/E
Ask Central	3.9	1.1	9.3
Caffè Nero	**5.5**	**0.42**	**29.4**
City Centre	3.7	0.64	9.1
Coffee Republic	1.5	0.15	neg
Domino's Pizza	8.5	0.94	13.5
Greggs	6.0	0.62	13.1
Inventive Leisure	6.2	0.91	8.7
Luminar	3.8	1.14	5.1
Majestic Wine	6.7	0.56	12.7
Pizza Express	10.4	1.20	13.4
Thorntons	4.4	0.68	12.9
Ultimate Leisure	6.8	2.04	6.6

Source: Numis Consumer Team Estimates

Strong EPS growth

On traditional valuation measures such as EV/EBITDA, EV/sales and PE, Caffè Nero trades on lower multiples than one would expect for a company in its early stages of growth. Whilst the PE looks high relative to the market and its peer group, we do anticipate a sharp increase up in earnings over the next few years.

EBITDA margin expansion

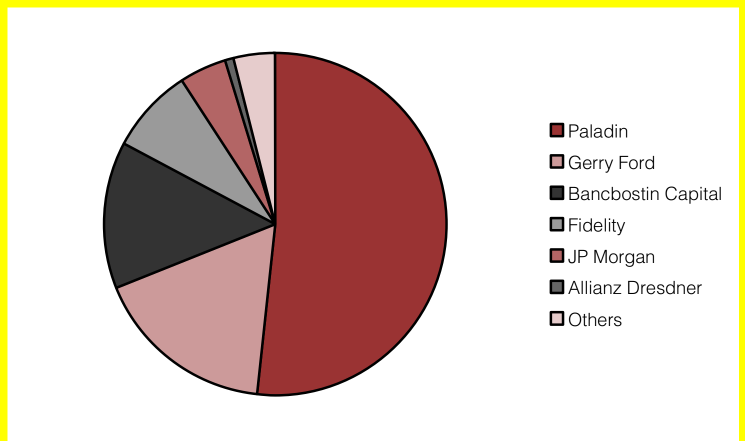
In table 16 below, we examine our forecasts for EBITDA margins for Nero and its peers. As the table demonstrates we believe Caffè Nero will continue to grow EBITDA margins.

Table 16 - Food retail sector EBITDA margins

Food retail sector EBITDA margins	2003	2004
Ask Central	21.4%	20.4%
Caffe Nero	**7.7%**	**7.9%**
City Centre	15.5%	15.6%
Coffee Republic	1.9%	3.7%
Domino's Pizza	11.7%	13.2%
Greggs	12.2%	12.2%
Inventive Leisure	18.6%	17.6%
Luminar	28.3%	27.8%
Majestic Wine	8.3%	8.3%
Pizza Express	18.6%	18.3%
Thorntons	14.7%	15.0%
Ultimate Leisure	30.3%	31.3%

Source: Numis Consumer Team Estimates

Chart –15 Major Shareholders



Shares tightly held

Caffè Nero's institutional shareholder base is small. This list must grow before the share price trades at a premium to its current rating in our view.

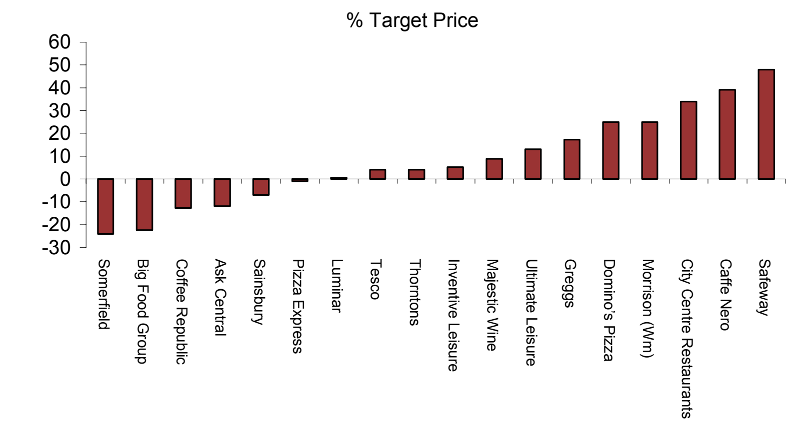
Summary

Table 17

Retailer/Operator	Price	Target Price	PER 03	ROIC	Yield	EV:EBITDA	Recommendation
Ask Central	130.5	115	9.3	23.1	0.5	3.9	HOLD
Big Food Group	58	45	16.5	5.8	3.1	4.6	SELL
Caffe Nero	**23**	**32**	**29.4**	**5.4**	**N/A**	**5.5**	**BUY**
City Centre Restaurants	56	75	9.1	9.0	6.4	3.7	BUY
Coffee Republic	1.57	1.37	Neg	-	N/A	1.5	HOLD
Domino's Pizza	100	125	13.5	12.5	2.7	8.5	BUY
Greggs	2925	3430	13.0	19.3	2.7	6.0	BUY
Inventive Leisure	95	100	8.7	11.5	2.1	6.2	HOLD
Luminar	301.5	300	5.1	7.5	3.6	3.8	HOLD
Majestic Wine	496	540	12.8	21.3	1.8	6.7	BUY
Morrison (Wm)	184	230	15.7	13.8	1.4	6.6	BUY
Pizza Express	390	385	13.4	6.7	2.9	10.5	HOLD
Safeway	261.5	390	11.9	7.1	3.7	6.8	BUY
Sainsbury	230	213	9.1	7.6	6.7	5.2	REDUCE
Somerfield	66	50	15.8	1.9	1.5	3.0	SELL
Tesco	196	205	12.8	10.1	3.2	8.3	ADD
Thorntons	133.5	140	12.9	7.4	5.0	4.5	BUY
Ultimate Leisure	176.5	200	6.6	12.4	2.8	6.8	BUY

Source: Numis Consumer Team Estimates

Chart 16 - % to Target Price chart



Source: Numis Consumer Team

As chart 16 demonstrates, Caffè Nero is one of our strongest buy recommendations in the consumer sector.

Chart 17 – Relative to FTSE 3 months

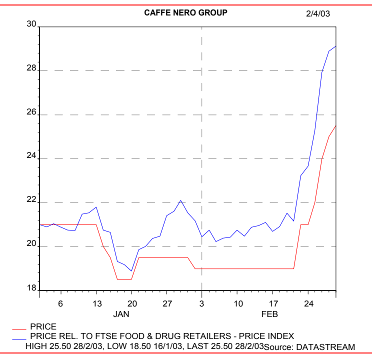
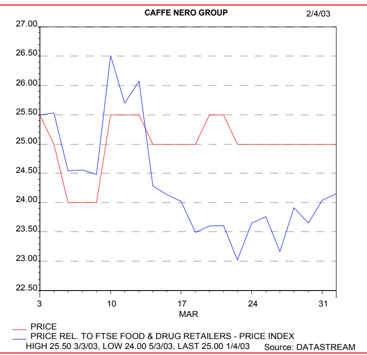


Chart 18 – Relative to FTSE 1 month



In summary, we like Caffè Nero for the following reasons:-

- Strong brand and offer
- Growth prospects for profits and earnings
- Good management team
- Strong space growth outside central London
- International prospects
- BUY Caffè Nero – target price 32p

Appendix

Table 18 – Caffè Nero Profit & Loss

Y/E June	2001A	2002A	2003F	2004F
Like for Like Sales	10%	2.0%	2.5%	3.0%
New Space	121.9%	68.0%	17.0%	21.0%
Change	131.9%	70.0%	19.5%	24.0%
Aroma Sites		0	8000	9000
Total sales	**15,647**	**26,600**	**39,787**	**58,336**
Total growth	132%	70%	50%	47%
Gross Profit	10,718	18,354	27,771	40,747
Gross Margin	68.5%	69.0%	69.8%	69.9%
Staff Costs	4068.2	6650.0	9906.9	14583.9
% Sales	26%	25%	25%	25%
% growth	132%	63%	49%	47%
Leases	3911.7	6384.0	9548.8	14000.6
% Sales	25%	24%	24%	24%
% growth	120%	63%	50%	47%
Other	2191	3458	4854	6650
% Sales	14%	13%	12%	11%
% growth	75%	58%	40%	37%
EBITDA	**548**	**1,104**	**3,461**	**5,513**
Depreciation	1,058	1828	2650	4050
% Sales	6.8%	6.9%	6.7%	6.9%
% growth	160.0%	72.8%	45.0%	52.8%
Other	0.0	66.0	0.0	0.0
EBIT	-1,011	-790	811	1,463
Exceptional	722	1102	0	0
Interest	490	398	500	680
Amortisation	364	386	380	380
Numis Pre-Tax Profit	**-1,501**	**-1,188**	**311**	**783**
FRS-3 Pre-Tax Profit	-2,587	-2,676	-69	403
No of Shares	42.735	67.6	67.6	67.6
EPSp	**-3.512**	**-1.757**	**0.461**	**1.158**

Source: Numis Consumer Team

Key Assumptions:-

- LFL sales growth of 2.5% for the full year. LFL's for H1 were 3% which had accelerated to 5.3% at the start of H2.
- We estimate that net margins will continue to increase from –3.0% in 2002 to 2.0% in 2003.
- We do not expect to see any dividend distribution over the next two years.

Table 19 – Caffè Nero Cashflow

Caffe Nero plc. Cash Flow Forecast	2000A	2001A	2002A	2003F	2004F
Operating Profit	-990.7	-2103.0	-790.0	811.5	1462.7
Depreciation	407.0	1058.0	1828.0	2650.0	4050.0
EBITDA	**-583.7**	**-1045.0**	**1038.0**	**3461.5**	**5512.7**
EBITDA margin	-8.7%	-6.7%	3.9%	8.7%	9.5%
Working Capital	887.0	1747.0	1375.0	500.0	500.0
Operating Cash Flow	303.3	702.0	2413.0	3961.5	6012.7
Interest	-258.7	-669.7	-403.7	-500.0	-680.0
Tax	0.0	0.0	0.0	0.0	0.0
Capex	-2740.4	-6882.8	-6151.7	-5000.0	-9000.0
Other	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	**-2695.7**	**-6850.5**	**-4142.4**	**-1538.5**	**-3667.3**
Dividends	0.0	0.0	0.0	0.0	0.0
Acquistions	0.0	0.0	-2540.8	0.0	0.0
Other	1067.0	11325.0	0.0	0.0	0.0
Coffee Republic Stake	0.0	0.0	0.0	-900.0	0.0
Net Cash Flow	**-1628.7**	**4474.5**	**-6683.2**	**-2438.5**	**-3667.3**
Other	0.0	1143.7	0.0	0.0	0.0
Opening Net Cash/Debt	-2115.0	-3743.7	1874.5	-4808.7	-7247.3
Closing Net Cash/Debt	**-3743.7**	**1874.5**	**-4808.7**	**-7247.3**	**-10914.6**

Source: Numis Consumer Team Estimates

Key assumptions: -

- EBITDA margins will increase rapidly from 3.9% in 2002 to 8.7% in 2003
- Capex will rise in 2004 to £9.0m as the group continues to roll-out new stores.
- The group will end the year with £7.3m net debt