

Caffé Nero

14 September 2004

Record results and 20% upgrade

Year to May	2003A	2004A	2005E	2006E
Turnover (£m)	39.4	50.5	67.6	84.6
EBITDA (£m)	4.2	6.5	8.8	10.6
CS pre-tax Profit (£m)	1.0	2.4	3.5	4.2
Tax (%)	-	0%	15%	30%
CS EPS (p)	1.5	3.1	3.8	3.8
Net Debt	5.4	9.4	13.3	14.7
Interest cover (x)	3.0	4.4	4.9	5.2
P/E (x)	65.3	31.6	25.8	25.8
EV/EBITDA	14.0	8.4	5.8	4.7

Final Results to 31 May 2004 and Upgrades

- Turnover up 28% to £50.5m driven by a net 41 new stores and an excellent 4% growth in like-for-like sales.
- Store profit 46% higher at £10.6m reflecting continued success of operating model.
- EBITDA + 56% to £6.5m and PBIT + 88% to £3.1m highlight operational gearing.
- PBT (adjusted) increased 127% to £2.4m compared to our upgraded forecast of £2.25m.
- Net debt at the end of the period was £9.4m and with EBITDA sufficient to fund 35 new openings (average expected annual roll-out) we see no need to raise additional equity to fund organic expansion in the UK.
- 162 stores were open as at the year end and this has since grown to 183. Following the acquisition of eight sites from Coffee Republic we expect around 44 new openings in 2004/05.
- 2004/05 has started strongly with turnover up 40% and like-for-like sales up 6.5%.
- We are upgrading our 2005 PBT forecast to £3.4m (£2.8m).

Summary

These were another set of impressive figures from a group that continues to over-deliver. Caffé Nero has demonstrated that you can make money from coffee shops and that the market is not saturated. The high quality of the Caffé Nero proposition and the excellent track record of the management team are beginning to be recognised by investors but in our opinion there is much further still to go. On our new forecasts Caffé Nero trades on a prospective 12-month rolling EV/EBITDA multiple of 5.8 and a P/E of 25.8. This appears undemanding for a group capable of delivering annual compound earnings growth of 30%-40% per annum over the next three years from the UK alone.

Collins Stewart Ltd is stockbroker to Caffé Nero Holdings plc and makes a market in the company's shares. As broker to the company, we make no recommendation and leave investors to draw their own conclusions over the potential for the shares.

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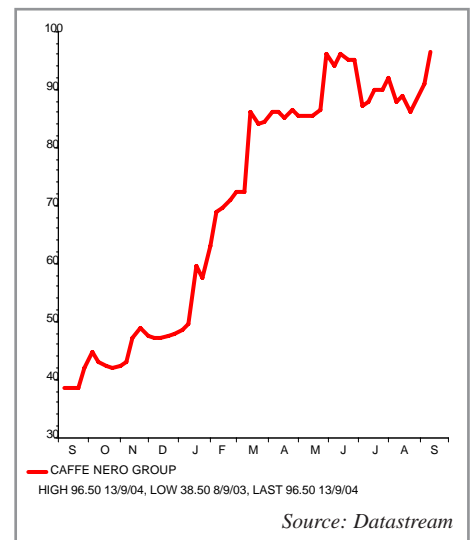
Smaller Companies Research

Price: 98p

Market Cap: £64.3m

Relative to	1m	3m	12m
FTAllShare (%)	+6	+1	+149
FTSE Small Cap (%)	+7	+3	+155

www.caffenero.com



Analyst:

Paul Compton

+44 (0)20 7523 8426

pcompton@collins-stewart.com

9th Floor, 88 Wood Street

London EC2V 7QR

Tel: +44 (0)20 7523 8700

Fax: +44 (0)20 7523 8140

www.collins-stewart.com

Background

Caffé Nero is the leading operator of Italian-style coffee bars in the rapidly growing UK coffee bar industry. As well as serving high quality espresso-based coffee there is an authentic offering of Italian style deli food.

The group was established in 1997 when Gerry Ford (Chairman and Chief Executive) acquired five central London sites and applied his concept of a European coffee house. Gerry gained experience in food and consumer businesses firstly through his time at APAX Partners and then through Paladin Associates, a private equity company that he co-founded. An early important appointment at Caffé Nero was that of Ben Price as Finance Director. Ben has ten years experience in the retail sector including a senior financial position at Dixons Plc.

In March 2001, the group listed on the main market by which time its estate had grown to 53 stores (there are currently 183 stores). Growth has been achieved both organically and via strategic acquisitions, the largest of which was the purchase of 29 Aroma sites from McDonald's in 2002.

For much of the group's early life as a public quoted company its share price suffered from the poor financial performance of many of its competitors (e.g. Coffee Republic, Maddisons). In addition, there were many sceptics in the investment community who believed that money could not be made in the coffee bar market and that the market was saturated. However, while many others have failed Caffé Nero has not only emerged as one of the three leading brands in the UK market but it has consistently exceeded financial projections.

The UK coffee market

The UK branded coffee bar market is worth around £630m (source: Allegra Strategies) and this is expected to grow to in excess of £1bn by 2008 representing an annual compound growth of c.12%.

At present three brands account for 57% of this market, Starbucks, Costa Coffee (Whitbread) and Caffé Nero. The group's share of the branded market has almost doubled over the past three years to around 11%. Despite this rapid growth the high quality offering has not been diluted. Indeed, in the 2004 Allegra report consumers ranked Caffé Nero as the number one branded coffee bar for the fifth consecutive year and top in all key categories (coffee quality, service, atmosphere and food offering).

Caffé Nero has established itself as the leading local market brand against the global brand of Starbucks. While Costa Coffee (320) has more stores than Caffé Nero this includes a large number of concessions.

Caffé Nero store model

The typical store is 800-1,500 sq.ft. and costs £200k to fit out. Pre-opening costs (£10k-£15k) are written off as incurred and taken at the central overhead level. The table below highlights the key financial profile of an average store.

£'000	Year 1	Year 2	Year 3
Turnover	325	365	400
Gross margin	69.5%	70.0%	70.5%
Gross profit	226	256	282
Rent	60	60	60
Rates/other property costs	30	35	42
Staff	90	85	85
Pre-opening	15		
Depreciation	25	25	25
Unit profit	6	51	70

Gross margins are high at c.70%, with food being lower and coffee as a raw material being in excess of 80%. The revenue split is typically 65:35 beverages and food.

Management see very little pressure on margins with any raw material cost increases being offset by improved purchasing power. Cost pressures are relatively subdued particularly in the area of rents, where competition for sites has reduced. Increases in the minimum wage do have some impact but this is more than offset by benefits from economies of scale and the operational gearing dynamics of a rapidly growing roll-out business that has achieved critical mass.

Why is Caffé Nero so successful?

While the coffee bar market has clearly enjoyed strong growth few companies (if any) can boast the financial performance of Caffé Nero. We believe that the group's success is due to a number of key factors.

A high quality and well defined offering – the concept is differentiated from market leader Starbucks (i.e. European versus North American). There is also a high attention to detail to create a truly authentic European coffee house environment that is supported by a high quality coffee and food offering.

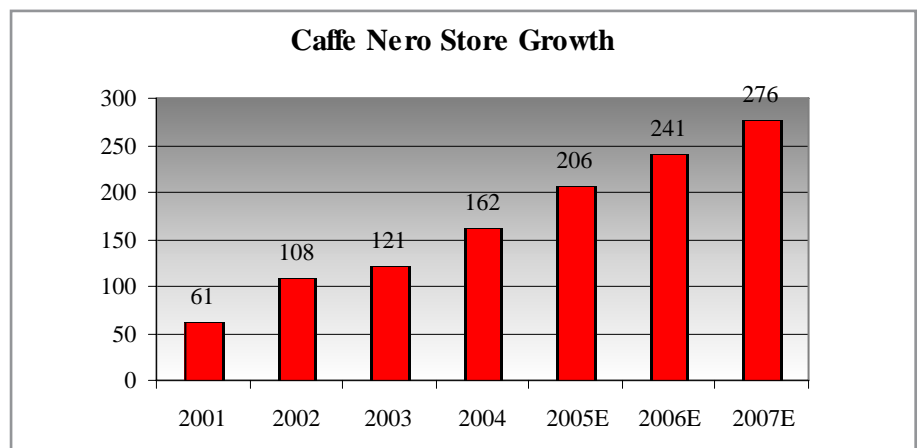
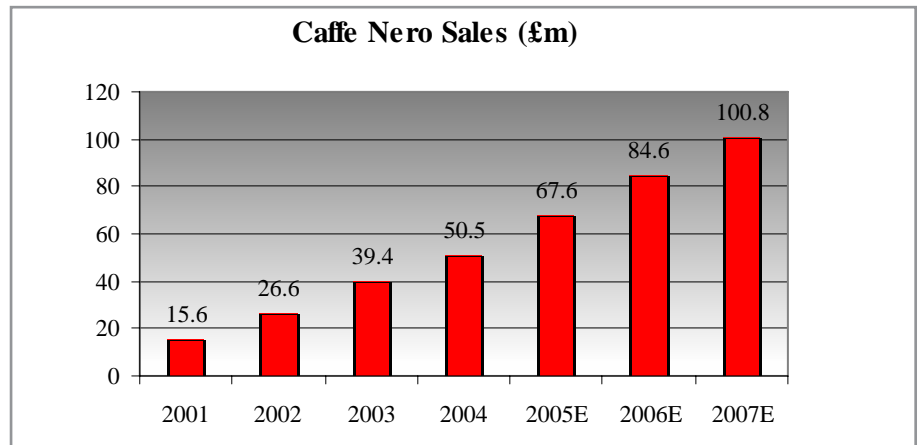
Selective site acquisition and disciplined roll-out – the group tends to avoid premium high street and retail park rents. Management have also resisted the temptation to take marginal sites simply to achieve greater store numbers. The roll-out is tightly controlled.

Focus on brand values – despite the success of the Caffé Nero concept management have remained focused on the core product. Numerous opportunities have arisen to accelerate the roll-out both in the UK and internationally but management are unwilling to sacrifice the core brand values.

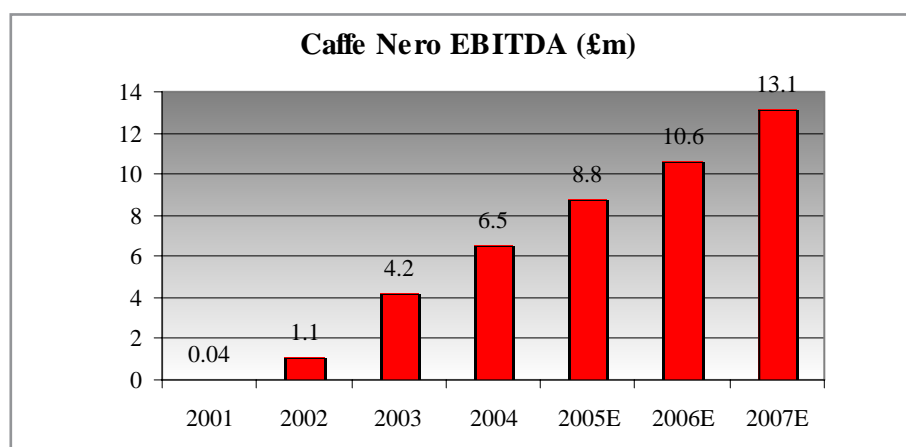
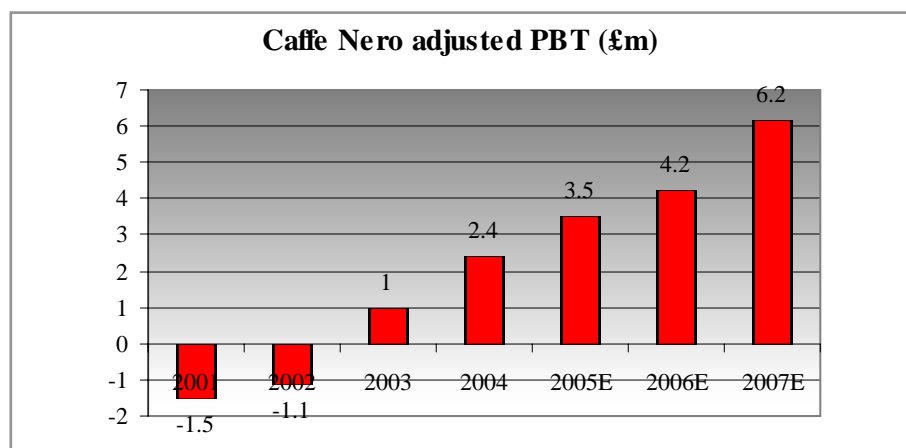
Final Results

As we have already stated these were an excellent set of figures with all key metrics exceeding our expectations.

Turnover rose to £50.5m from £39.4m a rise of 28%. While 41 net new stores were opened during the period there is a sales lag and the full benefit from these will not be enjoyed until 2005 (in 2003 there were just 21 net new store additions). Like-for-like sales increased by 4%, this was entirely volume-led. In our opinion, the top line is a reflection of the strength of the Caffé Nero proposition to consumers and if further evidence of the high quality of the offering was required the Allegra report on coffee 2004 once again ranked the brand number one overall.



Store level profitability increased by 46% to £10.6m reflecting a larger mature store base and the continued tight management of the roll-out. EBITDA reached £6.5m (£4.2m) as the benefits of operational gearing and the achievement of critical mass. Consequently, operating profits rose 88% to £3.1m.



After net interest of £0.7m (£0.6m) PBT (adjusted) increased by 127% to £2.4m. A deferred tax asset of £776k was recognised in the profit and loss account in accordance with FRS 19. Fully diluted EPS (pre-amortisation and tax credit) increased to 2.31p (0.76p).

Net cashflow from operations was £7.5m (11.3p per share), while capital expenditure was £10.2m. In addition, the group spent £0.7m (including costs) buying back 2.9m shares at 20p a share. Net debt at the end of the period was £9.4m (£5.4m) representing gearing of 91% (65%). Interest cover was a comfortable 4.4x, with net debt just 1.4x EBITDA. With an additional £6.5m of bank facilities available to the group and internally generated cash (EBITDA) currently sufficient to fund c.35 new stores, we see little need for any additional fund raising to support the current organic roll-out.

Forecasts and Outlook

Management have stated that revenues and like-for-like sales are up by 40% and 6.5% respectively in Q1. This is a very encouraging start to the year and this together with the excellent performance in 2004 has led us to upgrade our numbers.

We are now projecting 206 stores by the 2005 year-end and 241 the following year. Capital expenditure on new stores is forecast to be c.£9m, in line with EBITDA. After interest, tax and maintenance capital expenditure, year-end net debt is projected to be £13.3m.

The group's financial performance to date has been a text book example of a successful roll-out.

We believe that over the next three years the group should be capable of achieving underlying earnings growth of 33%-40% per annum. Assuming a 30% tax charge this would give a price of 112p to 136p on a prospective 12-month rolling P/E.

Summary

These results were a further confirmation of the strength of the Caffé Nero business model and the high quality management. With the underlying coffee bar market in the UK continuing to show good growth the outlook remains exciting for the group.

In our opinion, the spectacular share price performance over the past year has simply offset the unjustified underperformance of previous years. With the potential for 33%-40% underlying EPS growth over the next three years from the UK alone the current rating is hardly demanding.

By 2007 we expect the group to be achieving over £100m of sales and EBITDA of around £13m from the UK store estate alone. At which point we believe the market capitalisation could be north of £100m. There is clearly still plenty of upside in the Caffé Nero share price both in the short and longer term.

Financials

Year to May	2002A	2003A	2004E	2005E	2006E	2007E
Stores						
Opening	61	108	121	162	206	241
New	47	13	41	44	35	35
Close	108	121	162	206	241	276
Average	84.5	114.5	141.5	184	223.5	258.5
Avg. store sales	0.299	0.344	0.357	0.368	0.379	0.390
Turnover	25.3	39.4	50.5	67.6	84.6	100.8
Store profit (£m)	4.1	7.3	10.6	14.2	17.3	20.7
Store margin	16.4%	18.5%	21.0%	21.0%	20.5%	20.5%
Overheads (£m)	3.0	3.1	4.1	5.4	6.8	7.6
%	11.7%	7.9%	8.2%	8.0%	8.0%	7.5%
EBITDA	1.2	4.2	6.5	8.8	10.6	13.1
Margin	4.7%	10.6%	12.8%	13.0%	12.5%	13.0%
Depreciation	1.9	2.5	3.4	4.4	5.3	6.0
%	7.5%	6.4%	6.8%	6.5%	6.3%	6.0%
PBIT	-0.7	1.7	3.1	4.4	5.2	7.1
%	-2.8%	4.2%	6.1%	6.5%	6.2%	7.0%
Interest		-0.6	-0.7	-0.9	-1.0	-0.9
PBT		1.1	2.4	3.5	4.2	6.2
Tax			0.8	0.5	1.3	1.8
%				15%	30%	30%
PAT		1.1	3.1	3.0	3.0	4.3
EPS		0.76	3.60	4.50	4.50	6.60
EPS FD		0.76	3.10	3.80	3.80	5.40
Avg no. shares			65.6	65.6	65.6	65.6

LONDON

Collins Stewart Limited
9th Floor
88 Wood Street
London EC2V 7QR
Tel: +44 (0)20 7523 8000

NEW YORK

Collins Stewart Inc
41st Floor
444 Madison Avenue,
New York, NY 10022
Tel: +1 212 652 9000

PARIS

Collins Stewart Tullett France
89-91 Rue du Faubourg
Saint-Honore,
75008 Paris
Tel: +33 (1) 49 24 19 17

DUBLIN

Collins Stewart
Alexandra House
The Sweepstakes, Ballsbridge
Dublin 4
Tel: +353 1 631 9030

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