W25568

DOMINO'S PIZZA ENTERPRISES (AUSTRALIA): WEIGHTED AVERAGE COST OF CAPITAL

Matthew Winkler wrote this case under the supervision of Professors Colette Southam and Paul Beamish solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

On November 4, 2020, Richard Coney, chief financial officer of Domino's Pizza Enterprises Limited (DPE), received a memo from Don Meij, DPE's managing director and chief executive officer. In planning for 2021, DPE would need to make considerable investments throughout its franchises in Australia, New Zealand, Japan, and Europe. Many of these investments were related to processes established in early 2020 in response to the World Health Organization (WHO)'s recommendation[1] for swift action by corporate leaders during the first wave of the COVID-19 pandemic. DPE had undertaken immediate action but still faced the considerable task of managing and coordinating its global response as Europe moved into a second wave. The cost of capital would be integral to these investment decisions. In the previous year, DPE had made A$98.9 million[2] in investments,[3] so the difference of a few per cent in capital costs could mean a swing in millions of dollars in expenditures.

Several challenges loomed. By November 3, 2020, Europe had recorded 10.5 million cases of COVID-19 and saw a daily increase of 251,000 cases as most countries across Europe entered a second round of lockdowns.[4] The Reserve Bank of Australia (RBA) announced a rate cut to 0.1 per cent and quantitative easing of $100 billion.[5] Additionally, the world watched in anticipation as Joseph Biden Jr. was elected president of the United States. The year ahead would undoubtedly bring many challenges. DPE would need to respond effectively to the lockdowns in Europe, the RBA announcements, and the resulting implications of the US election. Coney's team of financial advisors (the Team) would soon meet to discuss these important challenges and their potential impact on DPE's cost of capital. The Team had to estimate DPE's cost of capital, an essential tool for the discussions and decisions ahead.

[1] António Guterres, "Opening Remarks to the Media during a Press Encounter at the World Health Organization," United Nations Secretary-General, February 24, 2020, https://www.un.org/sg/en/content/sg/speeches/2020-02-24/press-remarks-encounter-world-health-organization.
[2] A$ = AUD = Australian dollars; US$1 = A$1.3615 on November 30, 2020; all dollar amounts are in A$.
[3] Domino's Pizza Enterprises Limited, "Cash Flow Standardized," Bloomberg LP, accessed January 24, 2021.
[4] Richard Ogier, "Germany Is Moving Back into Lockdown, But It Hasn't Suffered the Same Fate as Europe," ABC News, November 4, 2020, https://www.abc.net.au/news/2020-11-04/germany-coronavirus-lockdown-avoided-same-fate-as-europe/12843140.
[5] Rachel Clayton, "Reserve Bank Cuts Interest Rates to Record Low of 0.1 Per Cent during COVID-19 Recession," ABC News, November 3, 2020, https://www.abc.net.au/news/2020-11-03/rba-cuts-interest-rates-record-low-coronavirus-pandemic/12838760.

BACKGROUND ON DOMINO'S PIZZA ENTERPRISES

Based in Brisbane, Australia, DPE began its international expansion in 2001 by first moving into New Zealand and then purchasing a master franchise licence agreement for regions across Europe and then Japan.[6] The full year financial results for DPE, released on June 28, 2020, were in line with expectations (see Exhibits 1 and 2). The year prior had been one of considerable consolidation for DPE with the rebranding of newly acquired Hallo Pizza in Germany. The DPE network store count stood at 2,668 globally, with 1,161 in Europe, 833 in Australia and New Zealand, and 674 in Japan. Network sales were up 12.8 per cent, with same-store sales (SSS) increasing 5.8 per cent. Network growth had been propelled by strong growth in Japan, with earnings before interest, taxes, depreciation, and amortization (EBITDA) growth of 42.3 per cent in the half yearly growth period in Japan alone.[7]

Success for DPE was heavily reliant on technical innovation, notably the implementation of Project 3Ten, which aimed to have pizza ready for takeaway in three minutes and delivered in 10. Investment in training and technology, such as predictive ordering, had resulted in record delivery times of two minutes, 28 seconds in Japan and three minutes, 36 seconds in the Netherlands in 2019.[8] The speed of delivery was heavily dependent upon the distance of the store from the customer, with DPE focusing on a heavy penetration and a store fortressing strategy. By building more stores to service an area, operations would improve, dramatically increasing the speed of delivery, which drove SSS. Across the network in 2020, 209.4 million pizzas were sold: 68.6 million in Europe, 105.6 million in Australia and New Zealand, and 35.2 million in Japan—all record sales numbers.[9]

However, while a high store count had proved strategically advantageous, with the coming challenges the complexity of the network now posed a great challenge. With 2,668 stores across nine countries, DPE needed to undertake considerable planning to ensure operations were maintained. The board opted to act fast early in 2020 and invested early, following the WHO's advice. Preliminary actions and phase 1 initiatives for the Team included purchasing about 15 million items of personal protective equipment and safety equipment; implementing safety standards including increased frequency of cleaning, sanitization, and the modification of kitchens to comply with social distancing; ensuring global supply chains would withstand potential shutdowns; developing communication and education plans for customers, employees, and suppliers; and rapidly developing a Zero Contact Delivery protocol.[10]

These additional costs increased operating expenses across the network. The decline in revenue could, however, be offset by gains if restrictions impacted consumption behaviours favourably for DPE as demonstrated during the first lockdown period in early 2020. With people working from home, store foot traffic had fallen, but delivery demand had increased, requiring reallocation or resourcing for deliveries. This could be the case again across Europe as a second round of lockdowns commenced: On October 29, 2020, French President Emmanuel Macron initiated a second national lockdown in France.[11] November 1 saw Belgium move into lockdown, and on November 2, Angela Merkel implemented a second lockdown across Germany. On November 3, the Netherlands tightened lockdown measures already in place in the country.[12] Lockdowns varied in duration but were estimated to last from two to six weeks.

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[6] "Who We Are," Domino's, accessed December 2, 2020, www.dominos.com.au/about-us/who-we-are.
[7] Domino's Pizza Enterprises Limited, *Annual Report 2020*, accessed December 1, 2020, https://investors.dominos.com.au/annual-reports/2020/8/19/2020-annual-report.
[8] Domino's, *Annual Report*.
[9] Domino's, *Annual Report*.
[10] Domino's, *Annual Report*.
[11] "Coronavirus: Macron Declares Second National Lockdown in France," BBC News, October 29, 2020, https://www.bbc.com/news/world-europe-54716993.
[12] Jon Henley, "Global Report: Lockdowns Start to Limit COVID-19 Spread in Europe," *The Guardian*, November 13, 2020, https://www.theguardian.com/world/2020/nov/12/global-report-lockdowns-start-to-limit-covid-19-spread-in-europe.

THE COST OF DEBT

In estimating the cost of debt, the Team decided to first establish the borrowing rates attached to the liabilities on DPE's balance sheet. When reviewing these, it was evident that some of DPE's liabilities, such as payables, did not have associated costs (see Exhibit 3). While 31.82 per cent of total liabilities were from bank loans, this represented 42.5 per cent of the firm's interest-bearing debt. The Team calculated the weights and weighted costs of the existing interest-bearing debt (see Exhibit 3). In contrast to existing loan debt liabilities, DPE's cost of debt for fiscal year (FY) 2019 was 1.30 per cent.

The book values of the current debt represented historical costs, but COVID-19 had had a drastic impact on these rates. On November 3, 2020, the Australian government lowered the cash rate to 0.10 per cent, a historic low, and the corresponding one-year government bond yield rate was also very low (see Exhibit 4). Firms generally used a longer-term rate such as the 10-year or 30-year government bond rates to proxy for the risk-free rate. The Team noted that, given the current financial climate and the state of the global economy, the markets were not behaving as they normally would. In fact, the yield curve was steeper than normal.[13] By adding a credit risk spread to the government bond yield curve, a cost of debt might be derivable (see Exhibit 5 for corporate bond ratings and spreads).

DPE's effective tax rate had varied slightly over the previous four years, between a high of 31.18 per cent in 2016 and a low of 28.25 per cent in 2019 (see Exhibit 6). Due to the impacts of the German expansion via the acquisition of Hallo Pizza and the impacts of COVID-19, revenue had increased substantially, with pre-tax income of $203.4 million in FY 2020 compared to $159.4 million in FY 2019. However, the effective tax rate in 2021 was expected to change due to the pandemic. The Team would need to determine the most appropriate estimate of the corporate tax rate to determine the after-tax cost of debt.

THE COST OF EQUITY

Turning to estimate the cost of equity, the Team considered the application of the capital asset pricing model (CAPM). The CAPM showed the relationship between risk and the firm's cost of equity. In estimating the cost of equity calculation, 85 per cent of leading corporations and 100 per cent of financial advisers used CAPM or a modified CAPM to estimate the cost of equity.[14] The model had advantages and disadvantages and required the user to make many assumptions about each of its components. For example, when considering the market risk premium (MRP), while the market may historically have averaged between 4–5 per cent in highly industrialized economies, this might not accurately represent DPE's exposure across multiple markets, especially given the considerably high returns experienced in Japan with network sales increasing by 38 per cent. Bloomberg reported an Australian MRP of 6.25 per cent in 2020.

The Team next considered the beta of DPE's stock, which was currently trading at $84.70. The Team had four figures: a raw five-year average beta with a low of 0.85 and a high of 0.95, and an adjusted five-year beta with a low of 0.94 and a high of 1.07. The betas were calculated via a Bloomberg terminal, regressed against the Australian Securities Exchange (ASX) All Ordinaries. It was unclear which figure was most appropriate and how it factored into the equation. With 86.24 million shares outstanding, the riskiness of the stock against the market might be an essential factor in determining the cost of common equity.

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[13] Kate Duguid, "Treasuries-Yield Curve Steepest in Three Years as Market Awaits COVID-19 Stimulus," Reuters, December 12, 2020, https://www.reuters.com/article/usa-bonds/treasuries-yield-curve-steepest-in-three-years-as-market-awaits-covid-19-stimulus-idUSL1N2IY222.
[14] Robert F. Bruner, Kenneth M. Eades, Robert S. Harris, and Robert C. Higgins, "Best Practices in Estimating the Cost of Capital: Survey and Synthesis," *Financial Practice and Education* 8, no. 1 (Spring/ Summer 1998): 13–28.