

Financial Analysis of Domino's Pizza



Domino's®

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1.0 Introduction

According to Fridson and Alvarez (2011), Financial analysis is a very important tool in many fields and for all companies, like investment management, commercial lending, corporate finance, or extension of credit.

Domino's Pizza was established in 1960 by an American in Michigan. It opened 200 franchises by 1978 across America and its first British Branch happened in 1985. According to TheGuardian (<https://www.theguardian.com/>) in 2018 Domino's Pizza sold 90 million of pizzas. The United Kingdom delivered the food market anticipates a growth rate of 8% from 2018 to 2022. This growth in percentage, as per the national survey emanates from the inclination towards ready meals overcooking and preference to takeaway over dining in. It is estimated that the UK delivered food market is going to rise by 8% considering this to be the most advanced delivery market in the world. The main driving force behind the estimation is the availability of various digital platforms, convenience and the want for home entertainment. The fact that competition traditionally comes from major international pizza brands and local independent operators should be paid heed to. It is also anticipated that the weaker section of the consumer environment would try to increase the focus on value proportion. However, it is also aware of the fact that there are various digital aggregators that add to increasing competition.

The company is also looking at the following as opportunities and risks respectively arising from the market forces:

Opportunities:

- The introduction of new stores shall boost sales and penetrate the market deeper.
- The brand image of the company can be used to grab a major share in the pizza market.
- Further investment in the integrated model shall provide superior service.

Well, the company shall want to tap into all the above-mentioned opportunities, but it is not immune to the risks posed by the market at large which include:

Risks:

- There is every possibility that customers may opt for a cheaper pizza option.
- There could arise a risk of losing market share to other pizza brands.
- The younger audience who prefer one single app might lose connection considering the integrated model proposed to have been introduced.

Unlike many other restaurants listed in the UK, Domino's crafts a niche for itself by operating its business as a franchise model. The company can grow without a hefty capital investment but can generate high returns. The strategy framework used by the company involves focusing on the operational plan. It includes maintaining a balanced network with profitable and aligned franchises and corporate stores. The customer reactions and innovations of the franchise are often driven through leading and innovative use of digital capacity. The company is always trying to provide the customers with new ways to order and more and more ways to make payment ensuring that the whole process of experience with Domino's is made easier and prompt. The process of manufacturing is highly efficient and productive to ensure that quality is not compromised. The capital structure is quite effective with proper allocation of the same and strong foundation of capital. Also, the colleagues feel engaged and perform better as the company provides a great place to work in. The three main functions that run the store profitability are sales growth or boost in sales, food costs and efficiency of the labour.

2.0 Ratio Analysis

This Ratio analysis is a very useful tool for analysing the financial situation of a company. So that the manager can make strategic decisions. (Murthy, 2017)

According to Ohlson (1980), the accounting ratio is a method of controlling the effect of size on gross accounting numbers, thus, the process of comparing accounting numbers in cross-section and time, becomes easier.

Accounting ratios are considered a very important tool in the analysis of financial statements that give a defined meaning to the link between the items in the balance sheet and statement of profit and loss as shown in the financial statements. These ratios also help management make better decisions. They are an integral part of the financial reports' preparation as the ratios encourage and aid in comparisons across companies for the same period or for the same company over a different period of time.

2.1 Liquidity ratios

According to Vasiu et al (2015), liquidity ratios is a way to assess the degree of fulfilment of short-term obligations of an economic entity.

Liquidity ratios are those that measure how able is the company in ensuring its short-term liabilities are paid when they fall due. These ratios provide further insight into how better is the firm at managing its current assets ensuring that they are available when the obligations form current liabilities become due for payment. Also, the ratio provides information about the working capital management of a company. These ratios are such great metrics of the company's ability to pay its debts because it talks about how much can the company bear on its own before it seeks external resorts. They evaluate the possibilities of companies to meet their short-term obligations with the cash generated through the circulation of current assets. It is an indication of the smooth movement of the working capital. Only a few of the liquidity ratios used are the current ratio, the fast ratio, the cash ratio, the stock turnover ratio, the debtor turnover ratio and the creditors' business ratio. In our case, the current and fast ratios are calculated and further analysed for a better understanding.

According to Murthy (2017), the current ratio is the resultant fraction of current assets divided by current liabilities. This provides an understanding of the company's potential to meet its short-term obligations as and when they come up for payment. The quick ratio is strict and more stringent than the current ratio whereby it eliminates inventory and prepaid expenses from its consideration since these are difficult to liquidate quickly when compared to the others in the group on a relative scale.

The current ratio and quick ratio for the past 5 years for Domino's group Plc.:

	2018	2017	2016	2015	2014
Current ratio	0.69	0.64	0.89	1.25	0.95
Quick ratio	0.62	0.58	0.78	1.17	0.89

The current ratio for the company seems stable over the past two years but if looked at all the five years, it shows a falling trend. Similar is the case with a quick ratio where the ratio has increased from 2017 to 2018 but otherwise has been showing a falling trend. A higher quick or current ratio is preferred, like at least over one which is not so in the given case, so the company has to look into what is making its working capital look so.

2.2 Gearing ratios

Gearing ratios can also be referred to as the liquidity measures for the long-term that measure how well the company is supporting its debt. It checks whether there exists a proper balance between equity and debt. Debt ratio, debt-equity ratio and leverage ratio are examples of financial stability ratios or gearing ratios. These are also referred to as leverage ratios or

financial stability ratios. These ratios are a group of metrics that compare the company's debt to its shareholders' equity. It usually looks at how the company's operations are being funded, as in, how much of it is being funded by equity, and what proportion is being funded by the debt raised by the company. These find greater meaning in themselves when used as a tool in comparing the performance of a company to another company of similar standing in the same industry. A large gearing ratio means that the company is highly sensitive to any downward changes in the business. It indicates a higher degree of financial leverage for the company. These ratios are useful both internally and externally. For example, these are used by banks while providing loans to companies to make sure that they have proper backing for the loan they are advancing (Ohlson, 1980).

The debt ratio is calculated by dividing total liabilities by total assets. This is an indicator of the distribution of total debt in proportion to the total assets spread in the business. It measures the proportion of total liabilities to total assets. It tells us how well the available assets of the company are being utilised to pay off its liabilities. Speaking otherwise, it is that portion of assets backs the liabilities. A large debt ratio is an indication of greater leverage and also more riskiness.

The debt-equity ratio gives information about the way the assets of a company are financed, meaning, the proportion of assets that are financed by debt and the portion which is financed by equity. This ratio is an indication of debt in the capital structure in proportion to equity in the capital structure. This shows the reliance on debt versus the reliance on the equity of a business. A high debt-equity ratio indicates that the company might not be able to meet its debt obligations. It means increased pressure on the company to meet its interest and other debt obligations, thus creating pressure on being more profitable. Investors usually would opt for a lower debt-equity ratio as the interests in that case protected in the event of any decline in the business. An ideal debt to equity ratio is somewhere between 1 to 1.5. The following table

shows the debt ratio and debt to equity ratio of the company for the past five years from 2014 to 2018 in descending order:

Debt ratio	0.99	0.83	0.58	0.47	0.55
Debt equity ratio	158.4	4.90	1.39	0.89	1.25

The company marks a rising trend in the debt ratio indicating more leverage and increasing riskiness. A ratio beyond 0.6 is considered not good as it indicates that the business does not generate cash enough to pay for the debt. The increasing debt ratio is not a good sign. The horrifying part now appears when we look at the debt-equity ratio which is very shocking. This could be looked at as a special case scenario where the debt-equity ratio just jumped to another level in the year 2018. Giving a closer look at the group balance sheet and the section of shareholders' equity, it can be understood clearly that the major reason for such a huge leap in the debt-equity ratio is owing to the super reduction in retained earnings. The retained earnings have all been used up which were 52 in 2017 and now went on to show a negative 2.6 million in 2018.

2.4 Profitability ratios

According to Gabrusiewicz (2014), the main reason a company conducts business is to make a profit.

One of the many ways to arrive at the true profitability of a company is through the calculation of the profitability ratios of the company. Looking at some of the ratios in the report, it could understand what the financial statements represent and indicate against the data given superficially in the financial reports. The two most widely used ratios of profitability are gross profit margin, net profit margin, operating profit margin, and return on assets. As it goes

without mentioning that, for all companies, higher profitability ratios in comparison to its competitor or a prior period is an indication that the company is performing better relatively.

Gross profit is that portion of the revenue generated which is the residue after paying for the cost of goods sold or the cost of sales. It is called gross profit margin when expressed as a percentage of the sale. The gross profit margin provides a significant piece of information about the amount that is left with the company to pay for operating and non-operating expenses and to be able to be prepared for any surprising and unforeseen events of the future. It takes into its ambit, the major inflows and also outflows, both of which are akin to the business operations. Every company aims to earn a gross profit enough to cover expenses and to earn surplus beyond the expenses. After paying for all the operating expenses from the gross profit, anything that remains is called as operating profit. It gives an understanding of what the company is earning from its core operations and excludes any expenses that are not related to the business directly. This includes all expenses that are core to the business of the organisation and an increased operating margin is considered a good fortune for the company's performance (Lewellen, 2004).

The net profit margin is the figure that is looked at by the stakeholders and investors on particular which is arrived at after the final filtration. It indicates the company's net profit as a percentage of the revenue it generates. The expenses of the company including taxes paid are all deducted to arrive at the net profit figure. This cannot be regarded as the right tool to compare the profitability of companies between industries as various industries have diverse costs and financial structures. Maintaining a high net profit margin is fundamental to invite attention from investors as they are interested in the earnings per share which in turn is a result of net profit.

The following table shows the gross profit ratio and net profit ratio of the company for the past five years from 2014 to 2018 in descending order:

Net profit ratio	0.08	0.14	0.19	0.15	0.14
Gross profit ratio	0.41	0.41	0.40	0.39	0.37

There is one interesting observation to be made. The gross profit ratio is on the rise and the net profit ratio is on the declining front. Without even looking closely at the financials, it could be understood that the profit that is generated by the production or manufacturing process is not being maintained due to some inefficient practices in sales. There seem to have been greater administration costs which could have been due to the opening of new franchises. This reduction in net profit ratio can be condoned if the investment in administration and other expenses would pay off with increased sales and reduced administrative costs in the following periods. If it persists, then the problem should be further investigated.

2.5 Efficiency ratios

Efficiency ratios give an understanding of how well a company is using its assets and liabilities to its full efficiency internally. These ratios can be used to track the performance of investment banks and those of commercial banks too. Examples of efficiency ratios include inventory turnover ratio, asset turnover ratio, receivables, payables turnover ratio, etc. Stock turnover ratio or inventory turnover ratio, as the name suggests is the ratio shows how soon the company can convert its inventory into sales to generate revenue faster. It is used to assess the speed with which inventory or stock is replaced or sold over a given period of time. This is calculated taking sales as a numerator and average inventory as the denominator and can be converted and expressed in days that give a deeper understanding about the number of days that it takes for the inventory to be converted to sales. This ratio shows a wide variation when compared among industries because of different operating environments of various industries. High turnover is a good sign and it means that inventories are moving faster into production

phase while a low ratio could be indicating stacking up of obsolete inventory or maintenance of excess inventory than required. Placing orders through economic order quantity rule can help serve this problem.

The asset turnover ratio is the ratio that indicates the role played by the assets as a whole or how the assets of the company have been used to generate sales as required by the company. This gives an insight into the revenue generated utilising the assets of the company. A higher asset turnover ratio indicates that more sales are being achieved per dollar of investment made in assets. It shows whether the company is holding any idle assets that are not adding any value to boosting or generating sales whether directly or indirectly, as the case may be. The higher the asset turnover ratio, the greater is the efficiency of the company (Lev, 1969).

The following table shows the inventory turnover ratio and asset turnover ratio of the company for the past five years from 2014 to 2018 in descending order:

Inventory turnover ratio	37.03	31.82	27.92	35.01	40.69
Asset turnover ratio	1.37	1.48	1.63	1.80	1.77

The inventory turnover ratio is good if it shows a higher number. It means that the inventory of the stock gets converted into sales so many times as indicated by the number. In the given case, we see that the company in the question has an inventory turnover ratio of 37.05 times which is on a rise when compared to the past two years. This is a positive and healthy sign.

The company under consideration has a falling or declining asset turnover ratio. As already discussed, a higher ratio indicates an efficiently performing company. A falling trend in the asset turnover ratio indicates that the company is not efficiently using its assets to

generate sales or turnover. Though the fall or fluctuation is not great, it should still be paid attention to since it is on the decline.

3.0 Domino's VS Papa John's

According to Vasiu et al (2015) competitive analysis is a method to compare the company with its rivals, offering the opportunity to identify the weaknesses and strengths of companies.

Competitors of Domino's pizza are primarily Pizza hut, Little Caesar's pizza and Papa John's. Comparing the financials of Domino's pizza for 2018 with those of Papa Johns' gives the following table:

	Domino's	Papa John's
	2018	2018
Liquidity ratios		
Current ratio	0.7	1.0
Quick ratio	0.6	0.7
Efficiency ratio		
Inventory turnover ratio	37.0	53.4
Asset turnover ratio	1.4	2.8
Profitability ratios		

Net profit margin	0.08	0.0
Gross profit margin	0.42	0.02
Gearing ratios		
Debt ratio	1.0	1.0
Debt-equity ratio	158.4	1.9

The current ratio and quick ratio of Papa John's are 1 and 0.7 when compared to that of Domino's which is 0.7 and 0.6. Both these ratios show the performance of Papa John's to be better than that of Domino's. This indicates that Papa John's is better at managing the working capital. The inventory turnover ratio of Domino's is also good at 37 and 1.4, but those of Papa John's show better performance at 53.4 times and 2.8 times indicating more efficiency in the usage of their assets. The net profit and gross profit of Papa John's is almost negligible on which front if considered Domino's is performing better with 43% of gross profit percentage and 8% of net profit percentage. The debt ratio of both the companies looks similar at 1 but again owing to the significant reduction in retained earnings as it was already discussed earlier, the debt-equity ratio of Domino's just stands incomparable at 158.4 for Domino's while the competitor has a considerate ratio of 1.9. So, if profit-making can be ignored, Papa John's is otherwise performing very well on all other facets of the business. However, since profit-making is the motive of any business, it is Domino's that seems to have achieved this for the year 2018 (Altman, 1968).

Given all of this, one cannot look away from what the facts indicate stating that the company has been quite slow in earning revenue and making profit through optimum utilisation of its assets. The efficient management of working capital would include matching the payables and receivables correctly and making sure that the right number of inventories is available at any given point of time. Stocking inventory in huge volumes than what is required does show good numbers but finally results in losses, for a company in the food industry like Domino's pizza, if not handled properly. Also, the company has to look for a way to improve its asset turnover ratio. However, to do so, the company should not see to reduce assets by showing more than usual repairs or depreciation or selling off assets. Instead, it should look to improve sales and thereby increase the asset turnover ratio. Since the company has a good stock turnover ratio, taking measures to maintain the same will, in turn, reduce the number of days in which inventories get converted into sales, thus, keeping in pace with an ideal operating cycle for the business to perform well. Reduced receivables and increasing payables are an indication of a lack of liquidity in the organisation. This should be discouraged and eliminated by revising terms of accounts receivables and account payables.

The industry that Domino's operates in is a very competitive one that changes its dynamics with every passing day. Other than the competitors as mentioned above which are major, there are many other local competitors as well. This puts a lot of pressure on all the top branded companies one of which is Domino's. The material cost which is food in Domino's case is of great importance. Fluctuations in their costs cannot always be reflected in the prices of the final product as the company cannot afford to frequently change the price card of the pizzas which might make it lose its customer base. There also exists competition in acquiring franchisees that are eligible and meet the qualifications as required; otherwise, this could put the reputation of the brand image at risk. Otherwise, international expansion becomes a difficult task. The company should also take into consideration the constant need and requirement of

the customers who want the company to satisfy their changing taste needs with anticipated innovation in food from the company.

Domino's is already a market leader and because of its strong affiliations with beverage companies like that of Coca-Cola, it is leading the race. It has a low-cost business model with strong digitalisation used. It has a greater recall value which is supported by its huge investment in the advertising budget. Adding to this, the business model that is adopted in the form of royalties through franchises has only proved to add to the success formula of the business. The company-owned stores and the supply chain revenue, all show a successful track record over the past years if looked at keenly. The company always looks at amusing its customers by introducing something new either through newer dishes on the menu or through innovative technology. However, as already seen thoroughly in the ratios calculated earlier, the one issue that is to be pondered upon is the high debt that it holds and the wipeout of the retained earnings in the current year. This could create a great impact on the profitability of future periods also. This is because the environment is cost-conscious and any slight variation in price by a competitor can shift the customer base. This could exert pressure on the price of various products being delivered by the company.

4.0 Investment decisions

The following tables show the calculation of payback period, accounting rate of return or ARR, internal rate of return or IRR and net present value or NPV for the two projects under consideration:

Payback period:

Calculation of the payback period

Year	A	Cumulative	B	Cumulative
Initial investment	85		90	
1	10	10	40	40
2	20	30	35	75
3	25	55	7	82
4	65	120	40	122
	33.			
Payback period	5	years	3.2	years

Making an analysis of the data from the previous tables regarding the capital budgeting measures for the two projects, the measurements made indicate a more advantageous possibility depending on the respective result. Concerning the repayment period, it can be seen that a project that has a shorter return period can be considered better. In that case, it is observed that Project B has a shorter return period, and Project A has a longer period.

. In conclusion, project B is more advantageous in terms of this option, because the investment will be paid off faster. However, this method cannot be considered advantageous, as it does not take into account the time value of money, which is particularly important. At the same time, this method does not take into account the cash flow after the repayment period. Also, this method, according to Lefley (1996) does not take into account cash flows after the repayment period.

Accounting rate of return:

Calculation of accounting rate of return

Year	A	B
Initial investment	85	90
1	10	40
2	20	35
3	25	7
4	65	40
ARR	35%	34%

Regarding the accounting rate of return, it is the estimated rate of return of a project. The higher is this rate, the better it is. For the above projects, it can be seen that Project A has a higher accounting rate of return than Project B. While the accounting rate of return of the first one is 35%, that of the latter is 34%. In conclusion, because Project A has a higher value in terms of ARR of the two, the investment is more attractive. However, according to Levin (2007) the disadvantage of this measure must be taken into account, because, as in the case above, it does not take into the account time value of money.

Net present value:

Calculation of NPV

Discounting rate	10.25%	
Year	A	B

0	-85	-90
1	10	40
2	20	35
3	25	7
4	65	40
NPV	3.2	7.4

However, the most commonly used method of measurement is the Net Present Value.

Taking into account discounted cash inflows and outflows, Net Present Value is a measure that is useful to see if a project is profitable or not. It can be observed that the calculation results in a positive net present value for both Projects A and B. Since Project B has a higher NPV of 7.4, it is to be chosen over Project A that has an NPV 3.2. However, even here a disadvantage can be observed, namely that the chosen cost of capital used to reduce cash flow, is based only on the method of guessing the work. In this case, if the assumption is made wrong, it also leads to the wrong choice of project. Depreciation does play a role in the calculation of Net Present Value. However, though it is given that the depreciation is measured on a straight-line basis, it does not have significance here since there is no mention of tax rates, which otherwise would have an impact that could change the decision (Levin, 2017).

Internal rate of return:

Calculation of IRR

Year	A	B
0	-85	-90
1	10	40
2	20	35
3	25	7
4	65	40
IRR	12%	14%

The next measure calculated is the internal rate of return. The internal rate of return is the rate at which the net present value of the project becomes zero. It is the annualised rate an investment earns. It is a general rule that the higher the IRR, the higher is the return that is anticipated and lowers the IRR, lower is the return. Since it is an internal rate of return, it ignores external factors, being, risk-free rate, inflation and other financial risks. It is the hurdle rate that is considered while making decisions on whether to accept a project or not. If the return expected from the project exceeds the internal rate of return, it can be accepted and if the expected return is below the internal rate of return, it shall not be accepted. In the given case, since project B has a higher IRR of 14%, it should be preferred over Project A that has an IRR of 12% (Bora, 2015).

Conclusion

In conclusion, analysing all four measures, it can be seen that project B must be chosen, because it is more advantageous in terms of three of the measures. However, to understand in detail and to make a correct choice, information about tax rates is important, because this

measure could change both the final result and the decision taken. Also, in case of necessity, for the calculation of the NPV, any working capital investment must be taken into account. Next, the profitability index will be calculated. The resilience index is closely related to NPV, which provides the result in ratio and is an absolute measure, which is more useful when it comes to a situation of capital rationing.

The non-financial factors that play an important role in investing related capital budgeting decisions include:

Motivation and satisfaction of employees are to be paid attention to without which success can't be achieved.

The investment decisions can be affected by the changes in seasons or other climatic conditions. One major example that is non-financial is something very recent, being the spread of the COVID - 19 that has such a fatal impact on investment worldwide.

Manpower or labour availability is very important because irrespective of the amount of automation that is taking over the world there is a lot that is and will always be done manually which requires labour availability.

The policy of the government where the company operates also plays a very important role. The rules and regulations that are imposed by the government affect the decision about any investment being made.

Lastly, market trends do have a major impact on investment in a business. Increasing trends accelerate investment in projects while a falling trend reduces the investment to be made in any project or business.

Investment in fixed assets shall be a positive sign for business only if it results in a positive net present value. In the case of multiple projects, where a choice has to be made

among mutually exclusive projects, the project with greater net present value will have to win the race over others. One very important consideration to be remembered is that the company has discount the project's cash flows to their present value based on the risk associated with the earning of the cash flows. If a project's IRR is greater than its discount rate, it is to be accepted. On a similar note, if the riskiness looks like to be greater, the project should be evaluated at a high discount rate to arrive at the appropriate decision.

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