# Company Analysis: Fontana Limited (FTNA)

VMWM Research | November 9, 2020

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- Recommendation: **OVERWEIGHT**
- Price Target: $5.49
- Current Price: $ 4.72[1]

- Shares Outstanding: 1,249,374,825 units
- Market Value of Shares Outstanding: $5.897 billion[1]
- Financial Year End: June 31

## ABOUT THE COMPANY

The first Fontana Pharmacy was opened on November 30, 1968 at the Manchester Shopping Centre in Mandeville by Shinque (Bobby) Chang and his wife Angela.

Today, the company's operations have expanded to six pharmacy and retail store locations in St. Andrew (Barbican & Waterloo Square), St. James (Fairview), St. Ann (Eight Rivers Town Centre) and Westmorland (Beckford Plaza, Savanna-La-Mar). The company also operates an online shopping platform, which serves customers across the island and abroad.

Fontana's core business remains the sale of pharmaceutical products, but it has diversified its offering to include 'brand Jamaica' products, health, beauty and cosmetic items, household essentials, toys, school supplies and electronics among other product categories.

## CORPORATE STRATEGY

Fontana believes strongly in providing excellent customer service and its mission is to offer the widest variety of goods at low prices in a warm and friendly atmosphere. The company's growth strategy is to broaden its presence in key population centres and business districts across the island, ultimately making Fontana a household name.

## FINANCIAL INFORMATION

| | |
|---|---|
| **52-Week Range** | $50.51 - $79.99 |
| **YTD % Gain/Loss** | -17.28%[1] |
| **Trailing EPS** | $3.19 |
| **Book Value per Share** | $55.20 |
| **P/E (x)** | 18.62[1] |
| **P/B (x)** | 0.95[1] |
| **Dividend Yield** | 2.70%[1] |

**Outlook**

We expect that COVID-19 and related restrictions will weigh on Fontana's performance. Nonetheless, the addition of the new branch and increased sales channels are expected to offset some of these losses. In the medium to long term, we anticipate that FTNA will continue to grow by diversifying its product offerings as well as through expansion of its branch network.

**Projections and Valuations**

Using the average of a Discounted Cash Flow model with a required rate of return of 15.8% and a P/E multiple of 22x we arrived at a target price of **$5.49.**

**Risks to Price Target**

The company faces downside risks dependent on the length and the severity of the pandemic. If it has lasting economic effects, severely decreasing consumer income, the company may face challenges in maintaining its revenue and profitability. On the upside, however, a quick economic recovery from the pandemic, in addition to further branch expansions may allow FTNA to grow at a faster than expected pace.

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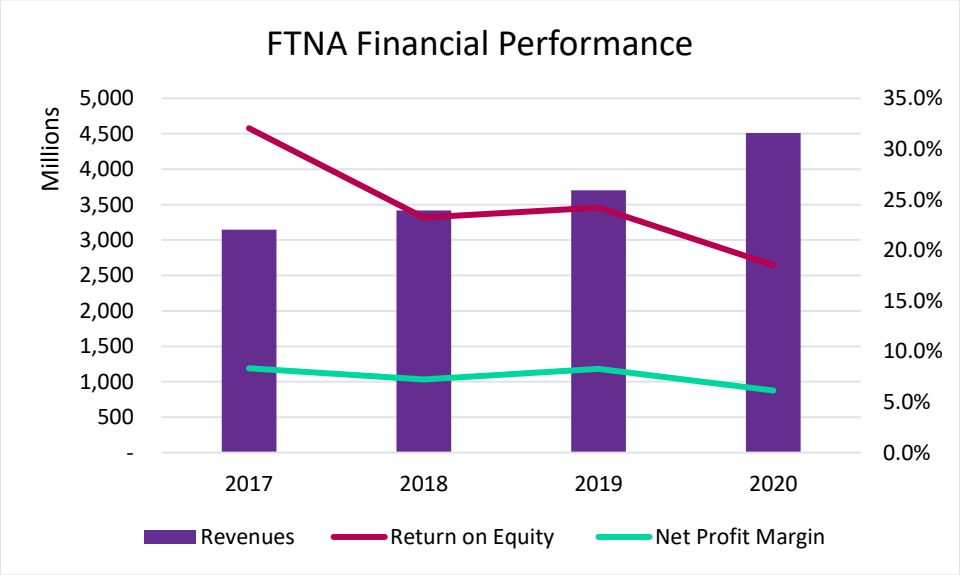
**FINANCIAL PERFORMANCE**

| | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|
| **Revenues ($M)** | 3,145.3 | 3,417.7 | 3,701.8 | 4,509.9 |
| **Gross Profit ($M)** | 1,217.8 | 1,289.1 | 1,323.6 | 1,698.3 |
| **Net Profit ($)** | 261.9 | 247.3 | 306.6 | 276.5 |
| **Net Profit Margin (%)** | 8.3 | 7.2 | 8.3 | 6.1 |
| **Current Ratio (x)** | | 2.09 | 1.65 | 2.12 |
| **Debt to Equity (%)** | 71.7 | 58.0 | 50.8 | 110.9 |
| **Return on Equity (%)** | 32.0 | 23.2 | 24.2 | 18.5 |

**FOR THE LAST FOUR (4) YEARS:**

Between FY 2017 and 2020, Revenue grew by a Compounded Annual Growth Rate (CAGR) of 12.8%. Though revenue growth, which averaged 8.5% in 2018 and 2019, was negatively affected by prolonged roadworks in Kingston and the state of emergency in Montego Bay, the addition of the Waterloo Branch contributed heavily to this growth. The company credits this growth to its strong brand initiative to provide a wide range of products at competitive prices, good customer service, customer engagement through its loyalty card programme and online sales to both Jamaican and international customers. The Gross Profit Margin fell from 39.7% in 2017 to 37.7% in 2020. Much of the decrease in the Gross Profit Margin is attributable to the increase in sale of beauty items which have lower gross margins. As a percentage of Revenue, Selling and Promotion Expenses have remained fairly stable averaging 2.2%. Administrative Expenses increased by a CAGR of 16.5%. The increase in this expense particularly in 2019 and 2020 is attributable to the increase in the management team and infrastructure as well as the addition of new positions in marketing, brand, beauty, among other areas. The increase in Revenue was not sufficient to compensate for the increase in Operating Expenses, leading to a decrease in the Operating Profit from $372.2 million to $367.6 million. Finance Costs also increased from $88.2 million to $155.4 million directly related to the increase in Liabilities. An increase in Other Income and Tax credits in 2019 and 2020, however, positively impacted the bottom line. Net Profit increased from $261.9 million to $276.5 million, correlating to a decrease in the Net Profit Margin from 8.3% to 6.1%.




FTNA's Balance Sheet more than doubled from $1.4 billion to $3.1 billion attributable to increases in most balance sheet items. Notable, Property, Plant and Equipment increased from $502.5 million to $769.8 million due to the recent expansion to Waterloo Square, inventories increased from $549.7 million to $650.6 million and Cash increased from $193.4 million to $599.3 million. The company also recognized a right-of-use asset valued at $839.8 million upon implementation of IFRS16: Leases, in relation to the lease of the Waterloo Square property. The increase in assets was funded primarily by the $222.6 million raised in its Initial Public Offering in 2017, a $153 million increase in Debt and the recognition of a Lease Liability valued at $920.2 million. This resulted in Liabilities and Equity increasing by 182.5% and 82.7% respectively. The company has maintained a high level of liquidity with a current ratio above

1.5x during the period and equal to 2.1x in 2020. The company's Liabilities have also increased significantly, resulting in an increase in the Debt to Equity ratio from 71.7% to 110.9%. This demonstrates increased solvency risks given that the ratio is above the benchmark of 100%.

**OUTLOOK:**

**COVID – 19 Expected to Affect Revenues and Profitability**

The novel Coronavirus has spread rapidly and has caused major disruptions in nearly all industries, including retail. We expect that while the pandemic will affect revenues as a result of social distancing and curfew measures, in the short term, the addition of the Waterloo branch will help to offset the decline in potential revenues, allowing the company to still record growth. However, FTNA's profitability may decline during the period as a result of supply chain disruptions and the introduction of new safety and sanitization measures. These factors are likely to increase expenses, thereby affecting Fontana's bottom line.

**Acceleration of Digital Sales Channels**

The onset of the COVID-19 has resulted in an acceleration of the digital transformation of many companies, Fontana included. The company has begun to implement alternative sales channels including delivery and online offerings, providing options for those who may not want to physically visit the store. In September 2020, FTNA announced a partnership with BlinkSky, a digital gifting platform, to launch Jamaica's first ever digital gift card. This allows for the sending and redemption of gift cards digitally. Through this service, customers will also be able to purchase gift cards for a range of popular international brands.

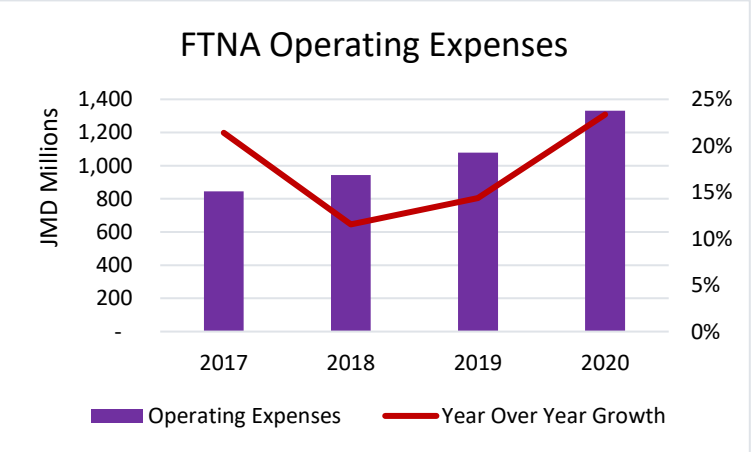
**'Craft' Market in Waterloo Branch to Encourage Young Entrepreneurs and Attract Attention**

Fontana has made a concerted effort to support small and medium-size Jamaican businesses by featuring local products in the stores. The $200 million plus investment will be used to develop a department of local artisans with locally produced products. Not only does this provide the small businesses with a wider audience, but it may help to drive in-store sales for Fontana.

**Further Expansion of Products Offered and Locations**

Management makes continuous efforts to identify new markets and customer segments. This is evidenced by the introduction of the craft market and recent branch expansion. The company has expressed interest in opening a branch in Portmore. Through this expansion, FTNA would increase its customer base and would likely result in similar revenue growth to when the Waterloo branch was opened.

**Expense Management will be Necessary for Continued Growth**




Despite the company's success in recent years, the rate of growth of its expenses are of concern. Between FY 2016 to FY 2020, Fontana's Operating Expenses increased by a CAGR of 14%, outpacing Revenue growth in each of the years under review. As at the end of FY 2020, Operating Expenses was 23% higher than the previous year-end, driven mainly by Staff Costs and General Office Expenses. While we expect that expenses going forward will normalize, given that much of the increase is associated with the opening of the new location, if the company continues on this trajectory, its longer-term profitability and thereby shareholder value will be negatively impacted.

**Tax Benefit**

FTNA will continue to benefit from a tax break associated with its Junior Market Listing. No taxes will be paid for the next 2 years, after which the company will be taxed at half of the corporate tax rate. FTNA will be able to retain these tax savings and use it to fund future growth.

## INVESTMENT POSITIVES

- JSE Junior Market tax concession will allow the company to retain more of its earnings for future growth
- Strong brand awareness, good customer service and rewards and loyalty programs will lead to increased customer retention
- Although Fontana operates in the highly competitive Retail and Pharmaceutical industry with low barriers to entry, it is a market leader in this space.

## INVESTMENT NEGATIVES

- Exposure to exchange rate fluctuations. A depreciation of the Jamaican dollar against that of its suppliers will increase the cost of inventory.
- High staff costs and Director remuneration.

## CONCLUSION

The introduction of the sixth store, the Waterloo Square location, in late 2019 undoubtedly improved Fontana's top line for its most recent financial year and we expect the new store to continue to positively impact the company's financial results. Despite operating in the consumer discretionary industry, Fontana has been able to record year on year Revenue growth despite the onset of COVID, due to its branch expansion and the accelerated development of other sales channels. Given the current performance, we expect that demand will remain relatively stable as the company will continue to reap the benefits of its new Waterloo branch. We anticipate further growth will occur if management opens a new store in Portmore as well as through a more diverse product offering. Nonetheless the company will need to control its expenses to allow the potential revenue growth to flow through to the bottom line.

Using a discounted cash flow method, with a required rate of return of 15.8%, we arrived at a fair value of FTNA of $4.29. Assuming a P/E of 22x, in line with FTNA's peer group average we arrived at a 2021 price target of $6.69. This results in an average price of $5.49, which is a 16.9% upside from current levels. Given these considerations, we recommend that investors **OVERWEIGHT** Fontana in their portfolio.

## SOURCES

The Jamaica Stock Exchange, Fontana Annual Reports and Quarterly Financials, LoopNews Jamaica, The Jamaica Observer, The Jamaica Gleaner

## DISCLAIMER



## DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.