Company Analysis: GraceKennedy Group Limited (GK)

VMWM Research | November 3, 2020

876-960-5000 | wealthinfo@myvmgroup.com | vmwealth.com | 53 Knutsford Boulevard, Kingston 5

- Recommendation: **OVERWEIGHT**
- Price Target: $65.08
- Current Price: $57.44 [1]

- Shares Outstanding: 995,012,431 units
- Market Value of Shares Outstanding: $57.7billion[1]
- Financial Year End: December 31

ABOUT THE COMPANY

GraceKennedy Limited (GKL), founded in February 1922, is a publicly listed company on both the Jamaica and Trinidad and Tobago Stock Exchanges. GKL is the parent company of the GraceKennedy Group.

The group operates through two main divisions: Food Trading and Financial Services. The Food Trading division, GK Food Services is responsible for the merchandising of general goods and food products both locally and internationally. It is also responsible for the processing and distribution of food products and the operation of the Hi-Lo chain of supermarkets. The Financial Services division has 3 categories: Banking and Investments, Insurance and Money Services. The group also has partial ownership in the following companies: Dairy Industries (Jamaica) Limited, CSGK Finance Holdings Limited, Catherine's Peak Bottling Company Limited and Canopy Insurance Limited (formerly GKMusson Limited).

SUMMARY

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 hold a positive outlook for GK as it begins a phase of cost containment and efficiency improvement. We believe that the company will benefit in the medium term from improved margins, reduced expense volatility, along with expansion through both organic and inorganic means.

Projections and Valuations

We project Revenue growth of between 6 and 7% in the long term, along with Net Profit growth of 5%. Using a Discounted Cash Flow Valuation model, with a required rate of return of 14.6%, we arrived at a fundamental value of GK of $65.08.

Risks to Price Target

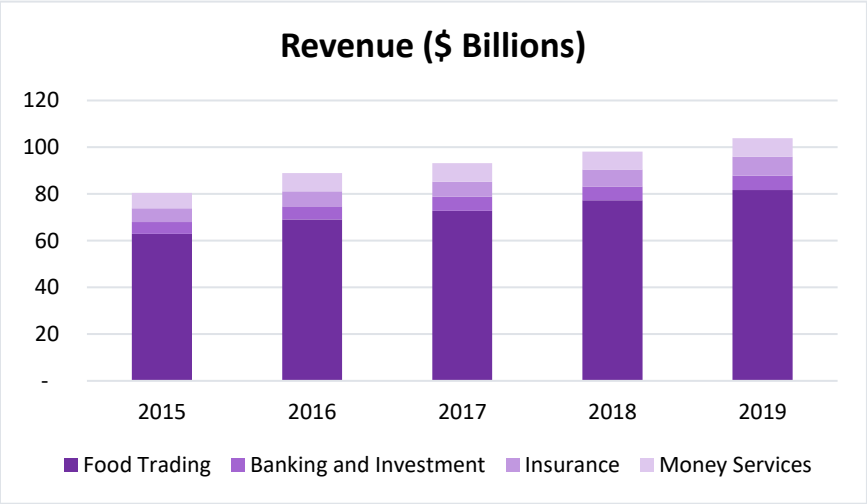
A slowdown in the global economy as a result of the coronavirus is one of the most prominent short term risks the company currently faces due to changes in supply and demand. On the other hand, if the newly formed mergers and acquisitions team is successful in finding inorganic growth opportunities for the group, the return to shareholders will be greater than anticipated.

[1] As at November 2, 2020

FINANCIAL PERFORMANCE

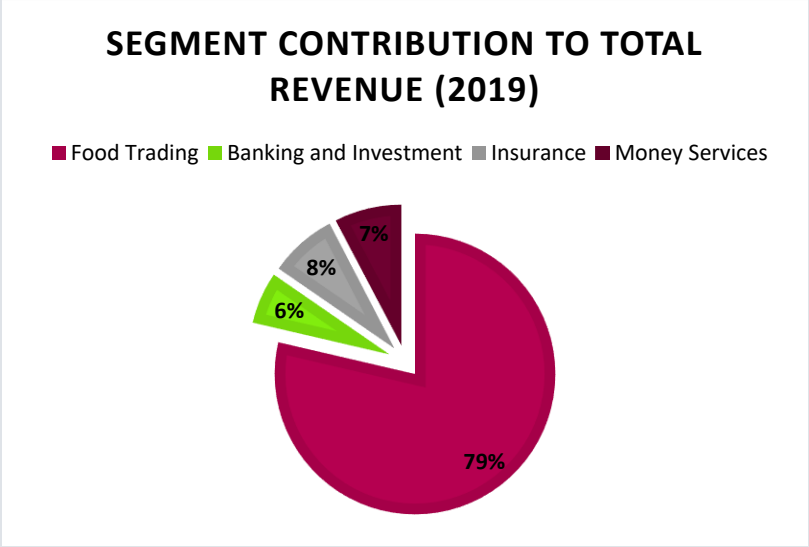
	2015	2016	2017	2018	2019	2019 H2	2020 H2
Revenues ($ Bn)	79.7	88.3	92.5	97.5	103.1	51.5	56.5
Expenses ($ Bn)	76.9	84.7	88.9	94.4	99.4	53.6	49.6
Net Income ($ Bn)	3.3	4.5	4.8	5.6	5.1	3.1	2.3
Total Assets ($ Bn)	108.7	126.5	130.0	135.2	154.7	150.3	163.6
Current Ratio (x)	1.36	1.34	1.38	1.32	1.24	1.25	1.24
Net Profit Margin (%)	4.1	5.1	5.2	5.8	4.9	4.4	5.4

FOR THE LAST FIVE (5) YEARS:



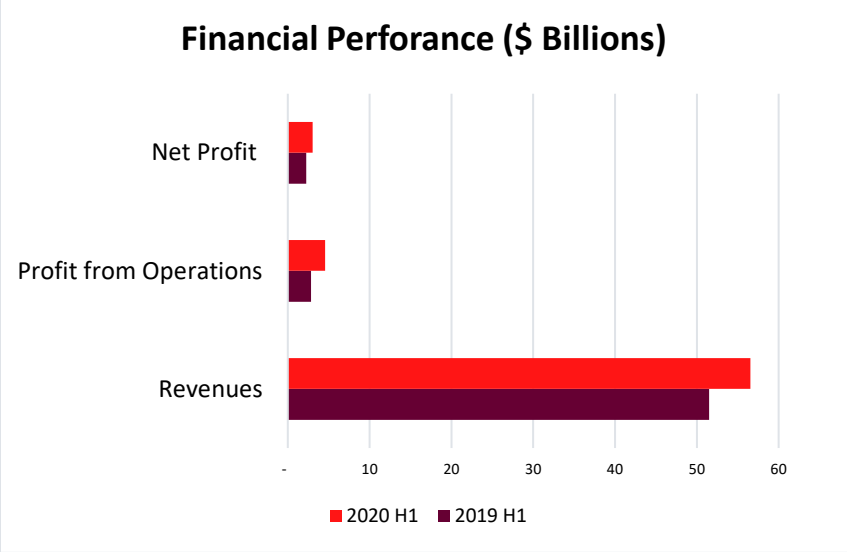
The GraceKennedy Group has continued to strengthen its performance over the past few years achieving its 2022 goal of becoming a $100 billion company 2 years ahead of schedule. Revenue increased over the last 5 years at a Compounded Annual Growth Rate (CAGR) of 6.8% from $79.7 billion to $103.1 billion in 2019. This is attributable to Revenue growth in all operating segments. Profitability increased over the period as measured by the Net Profit Margin increasing from 4.1% in 2015 to 4.9% in 2019. There was a fall in profitability in 2019, however, due to an increase in non-cash expenses associated with the implementation of IAS 19, a new accounting standard that details the treatment of pension benefits. Net income increased at a 5-year CAGR of 11.9% from $2.8 billion in 2014 to $5.1 billion in 2019. Over the period, profitability increased. The Net Profit Margin improved from 4.1% in 2015 to 4.9% in 2019 and Return on Equity increased from 8.4% to 10.1%.

GK's Insurance segment grew at the faster rate of on average 8.1%, while Food Trading and Banking and Investment recorded a CAGR of 6.7% and 5.2% respectively. In 2018, the group, in collaboration with Musson Group launched a joint venture now known as Canopy Insurance. This Insurance company was created to take advantage of new and developing technologies in the health insurance sector to provide greater service to customers. The Money Services division fared the worst with a CAGR of 4.7%. During the period, GK experienced challenges in this segment due to the enforcement of risk and compliance measures which stunted growth.



Total assets have increased by 42.3% over the review period from $108.7 billion to $154.7 billion. The increase was driven by a 181.8% increase in Fixed Assets, a 47.7% increase in Cash, 40.9% increase in Investment Securities and a 35.8% increase in Loans Receivable. The increase on the balance sheet was funded by a 44.2% increase in Total Liabilities and a 39% increase in Equity. The increase in Liabilities was caused by a 47.6% increase in Customer Deposits, and a 72.4% increase in Bank and Other Loans, slightly offset by a decrease in Securities Sold under Repurchase Agreements. The group has maintained adequate liquidity levels as its Current Ratio has averaged 1.33x over the period.

FOR THE FIRST SIX (6) MONTHS OF FY 2020:



In the first half of its 2020 financial year, Revenues increased by 9.9% year-over-year (YoY) to $56.5 billion, primarily as a result of the $3.8 billion (9.5%) increase in Food Trading Revenue, 19.3% growth in Insurance Revenue and 9.8% growth in Revenue from the Money Services segment. During the period, GK bolstered its Insurance operations with the acquisition of a 65% stake in Key Insurance Company, a Jamaican general insurance company. When combined, GK General Insurance and Key Insurance would control approximately 15% of the local general insurance market, behind market leaders British Caribbean Insurance Company and General Accident Insurance Company.

Effective margin management strategies implemented during the period allowed for increased operational efficiencies. Direct and Operating Expenses increased by 6.7% YoY, from $49.6 billion to $53.0 billion, while Impairment Losses on Financial Assets increased from $200 million to $502.0 million. This contributed to Operating Profit of $4.6 billion, versus $2.8 billion last year and an increase in the Operating Profit Margin from 5.5% to 8.1%. The increased profitability filtered through to the bottom line, despite increases in Interest Expense and Taxes. The Net Profit Margin improved from 4.4% last year to 5.4%, reflecting the 34.3% increase in Net Profit.

GK's Balance Sheet increased by 8.9% YoY, largely as a result of a 62.8% increase in Cash, a 13.2% increase in Receivables, an 8.2% expansion of its Loan Portfolio and a 12.5% increase in Fixed Assets. These increases were slightly offset by a slight decrease in Pension Plan Assets and Investment Securities. The increase in Assets was funded by an 8.9% increase in Liabilities and an 8.8% increase in Equity. The increase in Liabilities was largely as a result of a 36.5% increase in Payables from $23.2 billion to $29.4 billion. The bulk of the increase in Total Equity came as a result of a 10.0% increase in Retained Earnings as a result of the Profit Earned less dividends of $1.45 per share paid to shareholders during the period.

OUTLOOK:

Improved Margin Management and Efficiency for Greater Profitability

The company has plans to reduce its expenses and losses in several ways. In the food trading segment, GK will implement better margin management to increase the amount of revenue that flows through to the bottom line. The Food Manufacturing and Distribution industry structurally has lower margins. However, GK plans to implement new strategies to overcome some of these hurdles and improve profitability. Additionally, the group plans to better leverage technology to become more efficient. Some of the other cost saving strategies include improved management of foreign exchange volatility as well as finding measures to reduce the effect of the newly implemented IAS 19, which cost the company $1.2 million in 2019. Strategies implemented have proven fruitful during the first half of 2020. GK was able to increase profitability margins amid the pandemic through revenue growth, while other companies faced a deterioration in profitability.

Expansion of Products and Services in all Segments

The group plans to expand the products and services it offers in all its operating segments. SigniaGlobe Financial Group, a Barbadian bank associated with the group, has plans to expand its footprint to the wider Caribbean. This will increase the company's customer base and revenue, thus increasing GK's income. GK is also considering listing this associate on the Barbados Stock Exchange as a means of maximizing shareholder value. In insurance, the group has acquired 65% of Key Insurance Company. The group is expected to combine Key's business with its own general insurance company, GKGI, in order to extract synergies and make this segment more profitable. Canopy Insurance, the group's joint venture with Musson, is also reportedly beating the expectations of management and is expected to continue on this track. In terms of digital initiatives, GK is currently looking to launch 3 new digital capabilities including a prepaid card, the reintroduction of GK MPay and a mobile app. Within the Money Services operating segment, the group will digitize the way money is transferred offering multiple channels to its customers. As the industry for digital money transfer is growing at a much quicker rate than traditional money transfer, GK Money Services is expected to have greater growth on implementation of this service.

Growth Is Expected Through Mergers and Acquisitions

The group has noticed opportunities where it can either merge its operations with another company or acquire another company's operations for further expansion and growth. In order to adequately capitalize on these opportunities, the company has formed its own Mergers and Acquisitions (M&A) unit. This team's focus will be placed on identifying inorganic growth opportunities, allowing it to expand and achieve its future targets. At end of September 2020, the team had 10 M&A prospects in the pipeline spanning local and international food businesses and companies within the financial services industry in the eastern Caribbean and Jamaica. The key target of this unit is to position the group to earn 60% of its Revenue outside on Jamaica.

A Slowdown in the Global Economy will Have Negative Effects on The Group

According to the IMF, the global economy is expected to decline by 4.9% in 2020 as a direct result of the restrictions implemented to slow the spread of the Coronavirus. Th economy is projected to rebound in 2021 with 5.4% growth. However, global GDP would remain 6.5 percentage points lower than pre-COVID levels. We expect that the aggregate demand for GK's products and services will remain fairly resilient amid the pandemic, given that its revenue is concentrated within Food Trading, a consumer staple. Nonetheless, if the global economy does not rebound as expected, demand and revenue may fall. On the supply side, the availability of raw materials, a reduced labour force due to sickness as well as challenges with distribution may increase costs. While GK has been able to keep expenses low, risks of supply chain disruptions remain and will be subject to the length of this pandemic.

INVESTMENTS POSITIVES:

- GK has the capacity to continue expansion of its product and services in accordance with its customers' needs, as well as the general market.
- GK is a well-known brand by many, both locally and internationally.
- The geographic diversification of the company's markets reduces the risks associated with weaknesses in any one market
- GK has implemented a quarterly dividend policy, from which we can expect steady dividend payments.

INVESTMENT NEGATIVES

- Grace conducts business internationally and is therefore subject to the volatility of the exchange rate which can negatively affect revenue and profits.
- The majority of GK's products are not unique and therefore face significant competition from products and services of similar or better price and quality.
- A slowdown in the global economy is likely to reduce demand for GK's products and hence its profits.

CONCLUSION

Not only has GK's revenues been COVID-resilient, but the company has been able to increase its profitability amid the pandemic. While risks are heightened in the current operating environment, we believe that GK will continue to maintain and improve upon its current performance. We expect that the company will continue to identify and execute on its growth opportunities, particularly with the addition of the Mergers and Acquisitions team. We also expect that the company will continue to implement expense management initiatives to improve the current profitability and remove some of the volatility associated with its expenses.

Using a Discounted Cash Flow method, with a required rate of return of 14.6%, we determined GK's intrinsic value to be $65.08 per share. This represents a forward P/E of 14.12x and 13.3% upside from current levels. Therefore, we recommend that investors **OVERWEIGHT** GK in their portfolio.

SOURCES

The Jamaica Stock Exchange, GraceKennedy Group Annual Report and Audited Financial Statements, IMF June Report

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.