Company Analysis: Salada Foods Jamaica Limited (SALF)

VMWM Research and Stockbroking | December 10, 2019

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- Recommendation: SELL
- Price Target: $22.16
- Current Price: $30.00 [1]

- Shares Outstanding: 103,883,000 units
- Market Value of Shares Outstanding: $3.116 billion[1]
- Financial Year End: September 30

ABOUT THE COMPANY

Salada Food Jamaica Limited has been in the business of manufacturing and sale of coffee and other products since 1958. Salada manufactures consumer goods under the brands Jamaica Mountain Peak, Roberts and Pimora – Authentic Jerk Anywhere. The company has a fully owned subsidiary, Mountain Peak Food Processors Limited which is engaged in the distribution of Salada's core products in the local market. Salada also exports its products to Barbados, the US and Canada.

CORPORATE STRATEGY

Salada's current growth strategy involves entering new markets as well as seeking out new opportunities in existing markets. Selling and promotional activities will be done through social media as well as traditional mediums to convert brand awareness into sales.

FINANCIAL PERFORMANCE

	2015	2016	2017	2018	2019
Sales ($ M)	660.4	761.7	871.7	1,041.5	1,113.7
Gross Profit ($ M)	116.7	251.7	276.3	400.0	361.6
Net Profit ($ M)	31.7	68.9	68.7	219.2	141.4
Earnings Per Share ($)	0.40	0.72	0.67	2.12	1.37
Gross Profit Margin (%)	25.3	33.0	31.7	28.4	32.5

Outlook

We believe that Salada will continue to boost its revenue through the introduction of new products and other organic growth measures. However, we expect the company to continue to be affected by rising costs associated with the imposition of regulations which may subdue sales growth for SALF.

Projections and Valuations

Using a combination of a discounted cash flow valuation method with a 13.62% discount rate along with relative value approach, we determined a target price for SALF of $22.16 per share.

Risks to Price Target

Risk to our price target arises from the potential for disruption to the supply of coffee and other necessary raw materials locally, which may negatively impact Salada's cost structure.

[1] As at December 10,2019

FINANCIAL PERFORMANCE

	2015	2016	2017	2018	2019
Sales ($'000)	660,436	761,737	871,733	1,041,496	1,113,652
Gross Profit ($'000)	166,852	251,650	276,251	399,956	361,566
Net Profit ($'000)	31,652	68,900	68,686	219,177	141,367
Earnings per Share ($)	0.40	0.72	0.67	2.12	1.37
Gross Profit Margin (%)	25.3	33.0	31.7	38.4	32.5
Current Ratio (x)	9.32	5.30	6.31	5.16	5.01
Debt to Equity (x)	1.13	0.21	0.19	0.18	0.18

FOR THE LAST FIVE (5) YEARS:

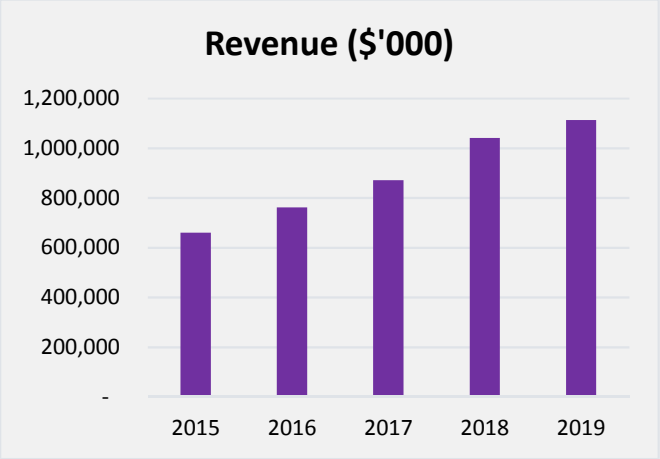
Over the last 5 years, Salada has increased its sales revenue from $660.4 million to $1.1 billion or by 68.6%. The increase in sales has mainly come from the local market. A strategic partnership with Lasco Distributors Limited has increased the marketing and distribution of Salada products over the years. On the other hand, sales growth in the export market was relatively weaker, comprising 22.8% of total sales in 2015, but only 11% of revenue in 2018. There was a rebound in 2019 as the company addressed challenges affecting sales in the New York leading to a 3.5% rise in the share of total sales comprising exports to 14.5%.

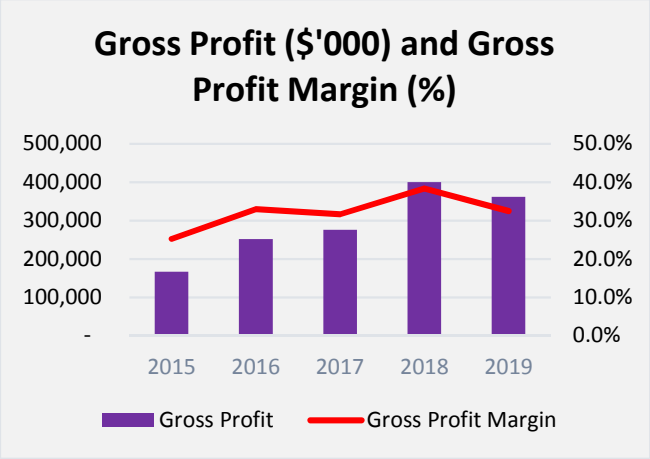
The gross profit margin has increased from 25.3% in 2015 to 32.5% in 2019, peaking at 38.4% in 2018. This is due to the shift in sales more towards the local market where unit costs associated with products sold are lower. Beyond the recovery in revenue share by the export arm, the introduction of a cess on the importation of green coffee beans of USD1.41 per kg in 2018 also weighed on gross profits. The cess was implemented in April 2018 and therefore its full impact was not felt in FY2018 as Salada only faced a $20 million charge during that year. The impact of the cess skyrocketed the following year, as Salada paid $81 million in cess on the importation of coffee beans.

Other operating expenses have increased by a CAGR of 6.52%, primarily due to inflation, while Net Income increased from $31.7 million to $141.4 million (347%) up to 2018. There was an interruption in the trend in FY 2019 with net income down 35.5% due to the impact of a full year of cess charges.

The company had two main uses for its excess cash, to purchase investment instruments and pay dividends. The total investments on books for the company have increased by $271.7 million or 109.1% over the time period. This led to a 54.2% increase in net finance income between 2015 and 2018. In 2019, the company earned negative net finance income due to a foreign exchange loss.

The current ratio for the company has decreased during the 5-years from 9.32x to 5.01x implying a decrease liquidity, though still at healthy levels. There was a 60.9% increase in current assets mainly due to the 850.7% increase in investments and the 31.1% increase in inventories. On the other hand, Current liabilities increased by 199.5% due to a 165.9% increase in accounts payables. The Debt-to-Equity ratio, which measures the solvency of the company, has also fallen over the last five years from 1.13x to 0.18x, on the back of the elimination of long-term liabilities coupled with consecutive years of growth in shareholder's equity as profits grew.





OUTLOOK:

Salada's brands are well-known in the coffee products niche, such as its flagship, Jamaica Mountain Peak brand and the newer Mountain Bliss 876. Growth in sales has been attributable to the success of its marketing campaigns locally which have targeted younger drinkers through social media and other online channels, as well as expansion in the Caribbean and North American markets. For FY2020, we expect growth to come primarily from an increase in exports and the introduction of new products.

Import Levies are Expected to Increase Cost of Raw Materials

The Jamaica Agricultural Commodities Regulatory Authority (JACRA) implemented a cess of up to USD 2.40 per kilogram on the importation of coffee beans. Salada currently incurs a cost of USD 1.40 per kg on green coffee beans imported from Mexico. Over $100 million has already been paid over the last two years due to this charge which has significantly lowered the gross profit margin. As the company continues to grow, this levy is expected to continue to impact the gross profit margin if Salada is to keep its Blue Mountain Peak brand consistent and a household favorite.

Industry Regulations Have the Ability to Decrease Revenue

In February 2019, JACRA insisted that Salada increases the local coffee content used in the manufacturing of the company's instant coffee from 10% to 30% by June 30, 2019. If the company fails to do so, JACRA may withhold further approvals to Salada to import green coffee beans. Salada's main concern is that this change will impact the integrity and the taste profile of its Mountain Peak Brand instant coffee. Such a change in the makeup of the product is likely to decrease sales if customers are not receptive of the change in the taste.

Growth to Occur Through the Launch of New Products

Salada has plans to launch 3 new products during the next year. We expect the launch of these products to drive further organic growth of the company's sales. Salada has also announced plans to launch a new luxury product using 100% Blue Mountain Coffee which it had purchased after limitations on the use of foreign coffee in Salada's products were announced. This brand will include premium roasted and ground coffee products which will help the company to appeal to a broader market.

The Opening of Starbucks and other Coffee Shops May Reduce Local Sales

Starbucks opened its first store in Jamaica in 2017. Today it has 5 locations in 3 parishes with plans to expand to 15 locations across the island. As more stores are opened, persons, especially the younger audience that Salada is targeting, may choose to buy coffee at a coffee shop instead of using Salada's products. This has the potential to decrease Salada's expected growth in sales.

INVESTMENTS POSITIVES:

- Consistently pays dividends
- Has a geographically diverse revenue streams
- The company's liquidity is strong
- The company's leverage as measured by the debt-to-equity ratio is low

INVESTMENT NEGATIVES

- Exists in a highly competitive market
- Experiences volatility in the availability and prices of raw materials
- Many substitutes are available
- The company is being closely monitored by regulators and may face further shocks to their cost structure from future sanctions and policies

CONCLUSION

We expect revenue to continue to grow on the back of the introduction of new products and further momentum in the existing product suite. However, under the watchful eye of their regulators the company will likely continue to face challenges to its cost structure if a solution involving a significant increase in the utilization of locally grown coffee.

Using a Discounted Cash Flow Model with a cost of equity of 13.62%, along with relative valuation model which considers the average P/E ratio of SALF's peer group as well as the company's average historical P/E ratio for a target forward P/E of 16.70x. Incorporating our expectations of the company's profitability and cash flow going forward, we determined a price target of $22.16 per share. This price represents a 26.13% downside from current levels, thus we recommend SALF as a **SELL.**

SOURCES

Bloomberg, The Jamaica Stock Exchange and Salada Foods Jamaica Limited Jamaica Annual Reports, Loop News Jamaica, Jamaica Gleaner, Jamaica Observer

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