GraceKennedy Limited

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Executive Summary

GraceKennedy Limited (GK) Limited was founded on February 14, 1922 and is listed on both the Jamaica Stock Exchange and the Trinidad & Tobago Stock Exchange. GK is constructed into two primary areas **Food Trading** and **Financial Services**. The company is further divided into four segments Food Trading, Banking & Investments, Insurance and Money Services. For the nine months ended September 2018, Food Trading constitutes the majority of revenue $58.54 billion or 79.29%. However, the Money Services segment is the most significant contributor to pre-tax profits $2.37 billion or 46.58% for the same period.

Food Trading (GK Foods) operations include food manufacturing, distribution of Grace and Grace-owned brands locally and internationally and operation of retail outlets. GK Foods has operations in several countries including Jamaica, Central America, North America, Africa, the United Kingdom and several European countries. Financial Services operates in the commercial banking, general insurance, insurance brokerage, investment banking, remittance, cambio and payment services business. **Majority of FY 2017 revenues was generated in three geographic areas namely Jamaica (51.54%), North America (25.98%) and Europe including UK (14.99%).**

We expect steady long-term growth for GK going forward in line with recent history. However, we project a decline in FY 2019 profits due to a decrease in other operating income from the elevated levels experienced in FY 2018. However, we expect GK to benefit from about $1 billion in tax credits from the Jamaica Urban Renewal (Tax Relief) Act (URA), will help lift profits in the near-term. While the long-term impact is limited given that GK's tax expense exceeds $1 billion per annum.

GK trades currently at about 15x trailing 12-months earnings significantly above FY 2014 levels of 6x. The company is a dependable dividend payer with an average payout ratio of 25.62% for the period FY 2013 to FY 2017. **Of note, since FY 2015 GK has paid dividends three times a year in May, September and December.**

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Recent Developments

For the 3rd quarter ended September 30, 2018 revenue rose 11.06% or $2.54 billion to $25.46 billion, however for the same period profits attributable to GK shareholders fell 25.42% or $362.39 million to $1.06 billion. This was partially due to separation costs of approximately $150 million and related expense of $86 million.

In September 2018 Signia Financial Group Inc. (SFG) which operates in Barbados acquired Globe Finance. GK owns 40% of the share capital in CSGK Finance Holdings Limited (GSGK), which was a 100% interest in SFG. SFG provides several services including term financing, motor vehicle leasing, acceptance of deposits, foreign exchange dealing and stock brokering.

GK has recently completed the acquisition of a 35% stake in Catherine's Peak bottled pure spring water and was appointed exclusive distributor.

Key Financial Data

	2014	2015	2016	2017	9M 2018[1]	CAGR[2]
BVPS	36.77	38.32	42.28	45.46	48.65	7.33%
EPS	3.30	2.78	4.04	4.15	4.04	7.94%
Dividend Per Share	0.78	0.83	1.02	1.13	1.35[3]	11.59%
Dividend Payout Ratio	23.49%	29.71%	25.14%	27.16%	21.05%	26.38%
Income Statement Data						
Operating Income($,000)	70,839,886	79,742,230	88,267,589	92,475,652	97,005,399	9.29%
Operating Income($,000)	4,625,439	4,364,174	5,966,759	5,619,235	5,369,603	6.70%
Other Income($,000)	1,730,117	1,571,132	2,383,733	2,088,006	2,706,648	6.47%
Pre-tax Profit($,000)	4,588,432	4,303,813	6,103,330	5,819,562	5,581,946	8.25%
Profits to GK Shareholders	3,285,174	2,759,498	4,004,539	4,116,101	4,018,095	7.81%
Balance Sheet Data						
Non-Current Assets	40,040,993	44,305,021	49,759,309	54,022,347	55,959,158	10.50%
Current Assets	61,818,536	64,388,423	76,719,740	75,966,293	81,070,262	7.11%
Total Assets	101,859,529	108,693,444	126,479,149	129,988,640	137,029,420	8.47%
Non-Current Liabilities	29,484,646	35,213,147	41,800,819	45,356,018		15.44%
Current Liabilities	34,129,911	34,107,245	41,139,722	37,620,509		3.30%
Total Liabilities	63,614,557	69,320,392	82,940,541	82,976,527	86,442,496	9.26%
Debt	11,064,160	13,396,107	13,242,037	16,515,615	15,560,581	14.29%
Equity	36,533,101	38,047,441	42,063,925	45,222,812	48,396,600	7.37%

[1] Trailing 12 month up to September 30, 2018
[2] For the period FY 2014 to FY 2018
[3] For all of calendar year 2018

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	2014	2015	2016	2017	9M 2018[4]	Average[5]
			Ratios			
Operating Margin	6.53%	5.47%	6.76%	6.08%	5.54%	6.21%
Net Profit Margin	4.64%	3.46%	4.45%	4.45%	4.14%	4.27%
Current Ratio	1.81x	1.89x	1.86x	2.02x	1.88x	1.89x
Debt-to-Equity	0.31x	0.37x	0.32x	0.37x	0.32x	0.34x
ROE	9.48%	7.40%	10.00%	9.43%	8.58%	9.08%
ROA	6.45%	2.62%	3.41%	3.21%	3.01%	3.92%
P/E	6.16x	9.74x	9.97x	10.56x	14.73x	9.11x
P/B	0.55x	0.71x	0.95x	0.96x	1.22x	0.79x
Adj. Close	20.34	27.08	40.29	43.84	59.49	30.77[6]%

Financial Overview

Revenue has increased consistently at a compounded annual growth rate of 9.29% for the period FY 2014 to FY 2017 (period under review). Food Trading has been the primary contributor to revenue growth increasing from $54.67 billion in FY 2014 to $72.61 billion in FY 2017. The next most substantial contribution to revenue is money services, but it only accounts for 8.48% of FY 2017 revenue. For the nine months ended September 30, 2018, all four segments except money services grew pre-tax profits. The decline for the nine months was due to reduced transaction volume in the first half of FY 2018 which stemmed from the implementation of enhanced compliance measures. Of note, while GK reported profits of $4.77 billion in FY 2017 the vital metric, profits attributable to GK shareholders was $4.12 billion. This was due to GK reporting non-controlling interest of $656 million. The primary reason for the non-controlling interest on GK's income statement is GK holding 75% interest in GraceKennedy Money Services Caribbean SRL (GKMSC). This remaining 25% of GKMSC not owned by GK accounts for $1.75 billion of the $1.79 billion in non-controlling interest on GK's balance sheet.

Total Assets has increased at a CAGR of 8.47% for the period under review to $129.99 billion. **The most significant assets at the end of FY 2017 are Investment Securities and Loans Receivables which constitute 24.50% and 21.19% respectively**. As at December 2017, $12.94 billion is invested in the Government of Jamaica securities making it the largest holding of gross Investment Securities of $36.78 billion for GK. Total liabilities have increased at a CAGR of 9.26% to $82.76 billion at the end of FY 2017 and has increased marginally to $86.44 billion as at the end of September 2018. The primary reason for the increased liabilities is increased deposits of $2.61 billion between the end of FY 2017 and September 30, 2018. Debt has grown at a CAGR of 14.29% for the period under review, but it has declined marginally to $15.56 billion at the end of September 30, 2018. Of the $16.52 billion in debt as at the end of FY 2017 $12.37 billion is unsecured and carry interest rates ranging from 2% to 10.13%. The unsecured loans of subsidiaries are supported by letters of comfort from GK, the parent.

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[4] Trailing 12 month up to September 30, 2018

[5] For the period FY 2014 to FY 2017

[6] CAGR

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Operating profit margin peaked in FY 2016, due to other income surging to its highest level for the period under review. The main reason for this surge was Net Foreign Exchange gain and Gain on Disposal of Investments for $785.39 million and $610.57 million respectively. Also, of note FY 2017 operating performance was boosted by $418.46 million on acquisition of subsidiary Consumer Brands.

GK has maintained adequate solvency for the period under review. Debt to Equity peaked at the end of FY 2015 at 0.37x but at the end of September 30, 2018 it is currently 0.32x. The DuPont analysis on ROE, indicated that the major contributor to ROE is financial leverage. Meanwhile, P/E and P/B ratios have expanded for the period under review. P/E expansion was due was due to the stock price increasing at a CAGR of 30.77% while earnings only grew at a CAGR of 7.81% for the same period.

Forecast and Valuation

We used the dividend discount model to arrive at our price target of $55.12. Innate in our price target is the assumption that the dividends continue to grow in line with the long-term sustainable growth rate of GK. This assumption seems fair given that over the period FY 2013 to FY 2017 dividends has increased at a CAGR of 11.59%. The top end of our forecast uses a combination of historical P/B and P/E ratios 5-year average applied to FY 2019 EPS projections. **We then used a two standard deviation increase in the P/B and P/E ratio above the five-year average to arrive at a best case price target of $64.70.** As indicated below GK appears relatively overpriced versus PJAM which has a lower P/E multiple and higher dividend yield, ROA and ROE. However, based on the P/B ratio GK appears more attractive versus PJAM. However, investors should note that PJAM's book value does not reflect the market value of PJAM's stake in Sagicor Group. GK does have better metrics than JP as indicated below.

Ticker	Market Cap(M)	P/E	P/B	Div Yield	ROA	ROE
GK	59,683	14.82	1.23	1.88%	3.44%	9.88%
PJAM	82,084	12.39	2.48	1.95%	11.91%	17.79%
JP	25,809	26.25	2.29	0.00%	2.12%	6.11%
Average	**55,859**	**17.82**	**2.00**	**1.28%**	**5.82%**	**11.26%**

Outlook

Our outlook on GK's financial performance is neutral because we expect the company to steadily improve profits attributable to GK shareholders in line with the historical performance for the period under review. However, in FY 2019 we expect profits to decline marginally from its FY 2018 levels. The main reason for this is GK has experienced unusually high earnings from other income for the first three quarters of FY 2018, we expect mean reversion and therefore ultimately decreased 2019 profitability.

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Key Risks to Our Price Target

The main risk to our price target is a decrease in pre-tax profits earned by GK Money Services (GKMS). For the nine months ended September 2018 GKMS accounted for 46.58% of GK's pre-tax profits. Therefore threats to this segment from new technology and increased regulation poses an issue. In FY 2017 GKMS and Western Union temporarily suspended operations at 10 locations of which at the end of year eight were reopened. The suspension of operations was due to GK's need to increase oversight.

Recommendation:

We recommend an **UNDERWEIGHT** rating on GK at this point given that the stock trades at an 8% premium to our base case price target. Additionally, compared to its peer PJAM, it is relatively 'expensive'. Also the potential for above average growth is limited given the size of the company and the highly competitive nature of the industries in which the majority of pre-tax profits is generated.

Source: http://www.Jamstockex.com, JMMB Investment & Research, Bloomberg, Various Company Financial Statements.

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

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UNDERWEIGHT—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

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