INVESTMENT AND SOVEREIGN RESEARCH October-3-2019

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GraceKennedy Limited

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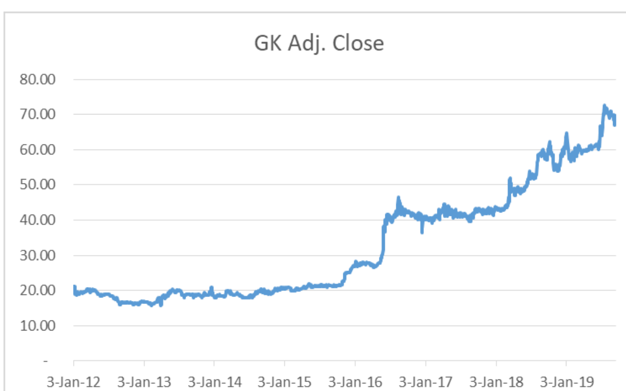
Executive Summary

GraceKennedy Limited (GK) was founded on February 14, 1922 and is listed on both the Jamaica Stock Exchange and the Trinidad & Tobago Stock Exchange. GK is structured into two primary divisions, namely **Food Trading** and **Financial Services**. The company is further divided into four segments Food Trading, Banking & Investments, Insurance and Money Services. For the six months ended June 2019, Food Trading constitutes the majority of revenue $40.93 billion or 79.49%. However, the Money Services segment is the most significant contributor to operating profits $1.43 billion or 41.62% 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. **The majority of FY 2018 revenues was generated in three geographic locations namely Jamaica (53.58%), North America (25.42%) and Europe including the UK (14.19%).**

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. We expect GK to benefit from about $1 billion in tax credits from the Jamaica Urban Renewal (Tax Relief) Act (URA), which can help lift profits in the near-term. However, the long-term impact is limited given that GK's tax expense exceeds $1 billion per annum.

GK currently trades at about 13.7x trailing 12-months earnings significantly above FY 2014 levels of 6x. The company is a dependable dividend payer with an average payout ratio of 26.44% for the period FY 2014 to FY 2018. **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 2nd quarter ended June 30, 2019 revenue rose 8.96% or $2.11 billion to $25.56 billion. Meanwhile profits attributable to GK shareholders increased 16.17% or $155 million to $1.11 billion. Operating performance in the quarter was aided by growth from the Banking & Investments and Insurance segments producing growth of 211% and 66% respectively. However, operating profit growth was curtailed by the Food & Trading segment which reported a decline in operating profit of 20%.

In May 2019 it was announced that GK and Musson Group formed a joint venture to provide Group Insurance, under an Ordinary Long Term Insurance Company, Canopy Health Insurance. Canopy is registered with the Financial Services Commission (FSC), and expects to begin operations in the second half of 2019.

Key Financial Data

	2014	2015	2016	2017	2018	CAGR	6M 2018	6M 2019	Change
BVPS	36.77	38.32	42.28	45.46	46.93	6.29%	46.60	51.03	9.52%
EPS	3.30	2.78	4.04	4.15	5.04	11.17%	2.17	2.02	-6.91%
Dividend per share	0.78	0.83	1.02	1.13	1.35	14.81%	0.40	0.75	87.58%
Adj. Close Price	20.34	27.08	40.29	43.84	63.50	32.92%	52.21	66.86	28.06%
Revenue	70,839,886	79,742,230	88,267,589	92,475,652	97,544,731	8.33%	48,368,563	51,489,502	6.45%
Operating Profit	4,625,439	4,364,174	5,966,759	5,619,235	6,626,524	9.40%	2,887,572	2,843,951	-1.51%
Other Income	1,730,117	1,571,132	2,383,733	2,088,006	3,486,010	19.14%	1,451,390	1,190,712	-17.96%
Share of Profit from Associated Company	230,906	316,191	441,151	484,972	490,873	20.75%	287,331	368,263	28.17%
Pre-tax Profit	4,588,432	4,303,813	6,103,330	5,819,562	6,963,025	10.99%	3,102,482	2,950,325	-4.90%
Profits	3,285,174	2,759,498	4,004,539	4,116,101	5,005,915	11.10%	2,153,694	2,011,447	-6.60%
Non-Current Assets	40,040,993	44,305,021	49,759,309	54,022,347	54,207,449	7.87%	52,595,471	68,269,349	29.80%
Current Assets	61,818,536	64,388,423	76,719,840	75,966,293	81,027,951	7.00%	82,924,880	81,984,592	-1.13%
Total Assets	101,859,529	108,693,444	126,479,149	129,988,640	135,235,400	7.34%	135,520,351	150,253,941	10.87%
Non-Current Liabilities	29,484,646	35,213,147	41,800,819	45,356,018	41,141,782	8.69%	42,609,920	44,617,288	4.71%
Current Liabilities	34,129,911	34,107,245	41,139,722	37,620,509	47,404,226	8.56%	41,446,370	52,518,407	26.71%
Total Liabilities	63,614,557	69,320,392	82,940,541	82,976,527	88,546,008	8.62%	84,056,290	97,135,695	15.56%
Debt	11,064,160	13,936,107	13,242,037	16,515,615	16,529,313	10.56%	13,216,177	22,404,695	69.52%
Equity	36,533,101	38,047,441	42,063,925	45,222,812	46,689,392	6.32%	48,464,061	53,118,306	9.60%

	2014	2015	2016	2017	2018	Average	6M 2018	6M 2019	Change
Operating Margin	6.53%	5.47%	6.76%	6.08%	6.79%	6.33%	5.97%	5.52%	-7.48%
Net Profit Margin	4.64%	3.46%	4.54%	4.45%	5.13%	4.44%	4.45%	3.91%	-12.27%
Current Ratio	1.81	1.89	1.86	2.02	1.71	1.86	2.00	1.56	-21.98%
Debt-to Equity	0.30	0.37	0.31	0.37	0.35	0.34	0.27	0.42	54.67%
ROE	9.48%	7.40%	10.00%	9.43%	10.89%	9.44%	9.67%	10.01%	3.52%
ROA	3.12%	2.62%	3.41%	3.21%	3.77%	3.23%	3.34%	3.40%	2.06%
P/E	6.16	9.74	9.97	10.56	12.62	9.81	11.86	13.29	12.11%
P/B	0.55	0.71	0.95	0.96	1.35	0.91	1.12	1.31	16.93%
Adj. Close Price	20.34	27.08	40.29	43.84	63.50	39.01	52.21	66.86	28.06%
Dividend Payout Ratio	23.49%	29.71%	25.14%	27.16%	26.72%	26.44%	18.39%	37.07%	101.51%
Dividend Yield	3.81%	3.05%	2.52%	2.57%	2.12%	2.81%	0.76%	1.12%	46.48%

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Financial Overview

Revenue has increased consistently at a compounded annual growth rate of 8.33% for the period FY 2014 to FY 2018 (period under review). Food Trading has been the primary contributor to revenue growth increasing from $54.67 billion in FY 2014 to $77.12 billion in FY 2018. The second largest contributor to revenue is money services, but it only provided 7.16% of FY 2018 revenue. For the six months ended June 30, 2019, the Banking & Investment (B&I) segment was the primary contributor to operating profit growth. B&I operating profit surged 94.50% or $167.59 million to $344.9 million for the six months ended June 30, 2019. Of note, while GK reported profits of $5.64 billion in FY 2018, profits attributable to GK shareholders was $5 billion. This was due to GK reporting non-controlling interest of $637 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).

Total Assets has increased at a CAGR of 7.34% for the period under review to $135.24 billion. **The most significant assets at the end of FY 2018 are Investment Securities and Loans Receivables which constitute 20.90% and 19.57% of total assets respectively**. As at December 2018, $12.88 billion is invested in GOJ securities making it the largest investment security holding of $38.19 billion. Total liabilities have increased at a CAGR of 8.62% to $88.55 billion at the end of FY 2018 and has increased meaningfully to $97.14 billion as at the end of June 2019. The primary reason for the increase in total liabilities is bank & other loans surging $5.9 billion for the six months ended June 30, 2019. Debt has grown at a CAGR of 10.56% for the period under review, but surged to $22.4 billion at the end of June 30, 2019, an increase of 35.6%. Of the $16.53 billion in debt as at the end of FY 2018, $9.97 billion is unsecured and carry interest rates ranging from 2.5% to 9.6%. The unsecured loans of subsidiaries are supported by letters of comfort from GK, the parent.

Operating profit margin peaked in FY 2018, 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 $833.3 million and $1.07 billion respectively. **The gain on disposal of investments was unusual relative to the FY 2013 to FY 2017 average of $191.3 million. Also, of note FY 2017 operating performance was boosted by a $418.46 million gain due to the acquisition of subsidiary Consumer Brands.**

GK has maintained adequate solvency for the period under review. However, debt to equity peaked at the end of June 2019 at 0.42x. While the debt-to-equity is still relatively low it does marginally increase the risk for the company. The DuPont analysis on ROE, indicated the improved ROE was due to increase profit margin and Total Asset Turnover. Meanwhile, P/E and P/B ratios have expanded for the period under review. P/E expansion was due to the stock price increasing at a CAGR of 32.92% while earnings only grew at a CAGR of 11.10% for the period under review.

Forecast and Valuation

We used the relative value method to derive our price target of $64.97. Innate in our price target is the assumption that the sentiment towards domestic equities remain in line with current levels. This assumption is fair given the low interest rate environment and the improving local economy. The top end of our forecast uses a combination of historical 52 week P/B and P/E ratios. **We then used a two standard deviation increase in the P/B and P/E ratio above the trailing 52 week average to arrive at a best case price target of $73.63.** We applied a similar method to arrive at our worst-case price target of $62.74. As indicated below GK appears relatively undervalued versus peers on P/E and P/B metrics and has a higher dividend yield. However, it's ROE and ROA is below its peer PJAM.

Ticker	Market Cap(M)	P/E	P/B	Div Yield	ROA	ROE
GK	68,604	13.71	1.35	2.39%	3.40%	10.01%
PJAM	110,785	14.66	2.82	1.05%	6.78%	16.91%
JP	26,415	25.64	1.96	0.51%	2.88%	8.20%
Average	**68,601**	**18.00**	**2.04**	**1.32%**	**4.35%**	**11.71%**

Outlook

Our outlook on GK's financial performance is neutral. 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, then returning to growth in FY 2020. The main reason for this is GK had experienced unusually high earnings from other income in FY 2018. This was due to reported gain on disposal of investments of $1.07 billion, we expect mean reversion and therefore ultimately decreased 2019 profitability. We see the Canopy joint venture as a potential avenue for material earnings growth in the medium to long-term. **However, given the market dominance of the notable players in the group life insurance industry, we are cautiously optimistic.**

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 six months ended June 2019, GKMS accounted for 41.62% of GK's operating profits. Therefore threats to this segment from new technologies and increased regulation pose an issue. In FY 2017 GKMS and Western Union temporarily suspended operations at 10 locations, and by year end, eight were reopened. The suspension of end operations was due to GK's need to increase oversight. Furthermore, a decline in remittances could materially impact GK earnings. For the six months ended June 2019, operating profit from the Money Services segment declined by 1.76% or $25.7 million.

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Recommendation:

We recommend a HOLD/MARKETWEIGHT rating on GK at this point given that the stock trades at a marginal premium to our base case price target. Additionally, GK's stock price is marginally below our best-case price target. The potential for above average earnings growth is limited in our view given the size of the company and a key generator of operating profit is experiencing a stall in growth.

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**.

PLEASE NOTE THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

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

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

HOLD/MARKETWEIGHT—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

OVERWEIGHT/BUY—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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