

Lasco Manufacturing Limited

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Executive Summary

LASM was incorporated in October 1994 and is a member of the LASCO Affiliated Companies and listed on the Junior Market on October 12, 2010. Lasco Manufacturing Limited (LASM) is domiciled in Jamaica with its registered office at 27 Red Hills Road Kingston 10 but, it operates from White Marl St. Catherine. LASM's range of products created at its dry plant includes LASCO Food Drink, LaSoy Lactose-Free, Porridge Mix, Enriched Milk Powder, Read Milk and Nutrify. Meanwhile, the liquid plant began operations in July 2014 and its portfolio includes iCool Juice Drinks, iCool Water, iCool Flavoured Water, iDrade, Lyrix and Konka.

For its FY 2019 profits tumbled by \$146.70 million or 20.74% to \$560.56 million. Meanwhile over that same period revenue fell \$291.74 million or 4.20% to \$6.95 billion. However, the company is off to a good start in the first half of FY 2019. For the six months ended September 30, 2018 revenue and profits have surged 8.64% and 49.18% respectively. However, the strength of the first half of FY 2019 is against the backdrop of performance in FY 2018 being depressed. **Comparing performance in the 1st half of FY 2019 to FY 2017 reveals revenue and earnings fell 3.91% and 14.31% respectively.**

We see several headwinds ahead including increased regulation and higher effective tax rates. Starting in January 2019 the Health Minister has restricted the sale of sugary drinks over a particular threshold in schools. **The Health Minister indicated that obesity in adolescence 13 - 15 years increased by 68% and doubled in boys over the past seven years.** The increased regulation could harm sales as more campaigns against sugary drinks are launched. LASM is coming to the end of its ten-year tax break in FY 2020, in October 2020. This will result in the effective tax rate increasing and could result in a decrease in after-tax profits even if pre-tax profits advance from current levels.

Over the past year, LASM has seen material multiple contraction. We see this as continuing given that LASM has been unable to generate strong profit growth, for reasons disclosed above.



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Company Summary

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Key Financial Data

	2014	2015	2016	2017	2018	CAGR
<i>BVPS</i>	0.61	0.76	0.94	1.09	1.20	18.73%
<i>EPS</i>	0.14	0.15	0.20	0.17	0.14	-1.05%
<i>Dividend Per Share</i>			0.025	0.030	0.035	18.29%
<i>Payout Ratio</i>			12.37%	17.34%	25.52%	18.41% ¹
<i>Revenue (\$000)</i>	4,023,673	4,788,583	6,571,742	6,951,627	6,659,891	13.43%
<i>Gross Profit(\$,000)</i>	1,056,363	1,423,540	2,384,874	2,560,160	2,439,650	23.28%
<i>Operating Profit(\$,000)</i>	458,797	645,252	1,247,370	1,493,152	1,581,783	36.25%
<i>Pre-tax Profit (\$,000)</i>	584,45	699.37	983.30	910.85	729.09	5.68%
<i>Profits</i>	584.45	612.36	826.20	707.25	560.56	-1.04%
<i>PP&E</i>	2,942,178	3,396,350	3,519,891	4,570,391	4,696,223	12.40%
<i>Current Assets</i>	1,707,067	2,095,179	3,335,850	2,479,197	3,001,220	15.15%
<i>Current Liabilities</i>	823,707	1,339,569	1,508,325	1,148,822	1,340,191	12.94%
<i>Total Assets</i>	4,649,245	5,491,529	6,855,741	7,075,299	7,723,154	13.53%
<i>Debt</i>	1,489,000	1,641,645	738,526	1,406,800	1,636,777	2.39%
<i>Equity</i>	2,475,789	3,088,150	3,855,265	4,439,905	4,922,953	18.75%
<i>Ratios</i>						<u>Average</u>
<i>Gross Margin</i>	26.25%	29.73%	36.29%	36.83%	36.63%	33.15%
<i>Operating Margin</i>	14.89%	16.60%	17.35%	15.37%	12.93%	15.43%
<i>Net Profit Margin</i>	14.53%	12.79%	12.57%	10.17%	8.42%	11.70%
<i>Current Ratio</i>	2.07	1.56	2.21	2.16	2.24	2.05
<i>Acid-Test Ratio</i>	1.15	0.99	1.67	1.60	1.61	1.40
<i>Debt-to-Equity</i>	0.60	0.53	0.19	0.32	0.33	0.9
<i>ROE</i>	26.47%	22.01%	23.80%	17.05%	11.97%	20.26%
<i>ROA</i>	14.83%	12.08%	13.38%	10.15%	7.58%	11.60%
<i>P/E</i>	8.60	7.68	18.75	28.89	30.05	18.79
<i>P/B</i>	2.03	1.52	4.02	4.60	3.42	3.12

¹ Average

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Financial Overview

Revenue has increased at a CAGR of 13.43% for the period FY 2014 to FY 2018 (period under review). In FY 2016 revenue grew by 37.24% or \$1.78 billion the most significant for the period under review. The growth in FY 2016 was aided by a 100% increase in capacity at its liquid plant. Also, the dry blend plant at White Marl increased capacity over its predecessor at Red Hills Road. However, in FY 2018 revenue waned as demand for beverages fell due to competitive pressures. More recently for the first half of FY 2019 revenue has increased by \$302.01 million or 8.64% to \$3.80 billion, due to increased sales volume. Over the period under review, pre-tax profit rose at a CAGR of 5.68% while profits fell 1.04% over the same period. The decline in earnings over the period was due in part to LASM's tax rate increasing as the tax break moved into its second phase. Meanwhile, pre-tax earnings were constrained by operating expenses growing at a faster rate than gross profit.

Current assets have increased at a CAGR of 15.15% to \$3 billion at the end of FY 2018. In FY 2018 62.25% or \$1.87 billion of LASM's current assets are accounts receivable on LASM's balance sheet. The receivables turnover ratio (RTR) of 3.95x below its 5-year average of 4.43x. For the period under review, the RTR has trended lower however as at March 31, 2018 only \$75.31 million or 5.27% of trade receivables was past due therefore the declining RTR is not yet of concern.

As at the end of FY 2018, LASM has \$926.63 million of long-term debt on its balance sheet, of which \$781.88 million is an expansion loan. LASM's expansion loan carries an interest rate of 8.70% per annum and matures August 31, 2021.

Gross Profit Margin has been reasonably consistent over the last three FYs peaking at 36.83% in FY 2017. Operating profit margin, however, has been on the decline since FY 2016. Operating expense increased at a CAGR of 36.25% over the period under review. The growth in operating expense is linked to increased advertising and promotion (AP) and depreciation expense. AP expense was \$90.09 million in FY 2015 and surged to \$300.57 million in FY 2018 and represents the second largest expense line item next to staff cost of \$507.37 million in FY 2018. While depreciation expense moved from \$67.10 million in FY 2015 to \$215.76 million in FY 2018.

A review of ROE using DuPont analysis reveals that the decline in EPS is mainly attributed to decreased net profit margin. Net Profit margin moved from 14.53% in FY 2014 to 8.42% in FY 2018. This decline in Net profit margin is due in part to a decline increased taxes and increased depreciation.

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Forecast and Valuation

We used the relative value method applied to the 5-year mean P/E and P/B ratios to arrive at the price target of \$4.56 per share using FY 2020 forecasted EPS and BVPS. Innate in our base case assumption is market sentiment remains at recent levels, leading to LASM maintaining average P/E and P/B multiple ratios over the past year. However, given a trend of P/E multiple contraction over the past year coupled with increased taxes in the near-term due to the tax reduced period coming to an end. **We expect further multiple contraction which will lead LASM's stock towards our price target of \$3.07.** Also LASM's P/E and P/B is above peers despite ROA being below peers. ROE is marginally above peers however, this may be partially due to the higher debt levels versus peers such as BPOW which has virtually no debt. **Applying the FCFE Model we arrived at a price target of \$3.79 which would result in a forward P/E of approximately 20x.** This model produces a price target in line with LASM's 5-year average P/E which adds to its credibility. **However, given the headwinds in the near to medium-term we reiterate our expectation for the stock to drift towards the lower end of our price target.**

<u>TICKER</u>	<u>MARKET CAP</u> <u>(\$M)</u>	<u>P/E</u>	<u>P/B</u>	<u>DIV</u> <u>YIELD</u>	<u>ROA</u>	<u>ROE</u>
LASM	13,419.02	21.77	2.73	0.00%	8.91%	14.65%
AMG	1,356.52	21.00	2.98	0.00%	6.34%	9.24%
BPOW	2,740.20	18.21	3.59	0.39%	14.41%	16.29%
CFF	1,708.48	18.80	4.09	0.00%	22.21%	24.47%
HONBUN	1,837.94	21.87	2.97	1.03%	11.58%	14.85%
JAMT	2,744.93	17.24	2.20	0.00%	7.82%	11.11%
KREMI	2,025.34	17.31	2.65	0.94%	13.01%	17.18%
PTL	3,162.06	91.98	4.27	0.00%	3.07%	4.91%
PURITY	0.463		0.65	0.00%	-1.38%	-1.83%
AVERAGE²		19.46	2.90	0.26%	10.92%	14.09%

Recent Developments

LASM plans to invest between US\$ 2 to US\$ 3 million in preparing for regulatory changes for sugary drinks. The ban on the sale of sugary beverages with more than 30 grams of sugar per 500 millilitres at primary and high schools beginning in January 2019 is also likely to impact sales of LASM's iCool and Lyrics branded products. **The actual impact of such will matriculate in Q4 2019 for LASM.** However, given that LASM also distributes a substitute product, iCool water some loss of revenue could be mitigated. **Another major concern that could occur shortly is the tax on sugary drinks which LASM expects could be implemented in 2019.**

² P/E average excludes PTL due to it being excessively high, ROE and ROA calculations exclude negative figures

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Outlook

We have an overall negative outlook on LASM, given weak growth of the past 5-years, intense competitive pressures and impending increased tax-rate. LASM has increased profits at a CAGR of -1.04% due in part to taxes, and while we see earnings growth steadily progressing going forward, we believe the explosive growth experienced in FY 2016 will be difficult to replicate. **Of note we see LASM's earnings exceeding FY 2016 levels at the earliest FY 2021.** Competitive pressures continue to mount as other large manufacturers such as WISYNCO has established brands in LASM's liquid plant products' market segment. **Finally, LASM is expected to begin paying full taxes in October 2020 which will further limit the ability to grow if not reverse it.**

Key Risks to Our Price Target

The company is unable to grow revenue at similar rates in the past. Also, if LASM should suffer any significant margin contraction, it could lead to operating and profit not meeting our expectations.

Recommendation:

We recommend an UNDERWEIGHT on LASM at this point given that the stock currently trades at \$3.36 a 9.44% premium on our price target of \$3.07. While our base case puts LASM's price target at \$4.56, we view this as too optimistic given curtailing P/E and P/B multiples and growth and expectations. **Additionally, we believe LASM has hit an inflection point, and therefore we also view our FCF model valuation of \$3.79 as too optimistic.**

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

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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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