JMMB EQUITY RESEARCH

Caribbean Flavours and Fragrances Limited (CFF)

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EXECUTIVE SUMMARY

Caribbean Flavours and Fragrances Limited (CFF), was established in 2001 and its shares listed on the Junior Market of the Jamaica stock exchange in 2013. In 2017, CFF became a subsidiary of the Derrimon Trading Group, as they increased their holdings in the company from just over 45% to 75%. CFF's principal activities include the manufacture and distribution of flavours, mainly for the beverages, baking and confectionary industries. At the onset of the COVID-19 pandemic, the company began producing its own brand of hand sanitizers.

Over the period FY2017 - FY2020, CFF grew revenues by a compound average growth rate (CAGR) of 13%. CFF had record revenues of $593M in the 2020FY, as the company capitalized on opportunities provided by the pandemic. Revenues for the 1st quarter of the 2021FY declined by 10.5% from $149M to $133M, as the flavors section of the business continues to experience a slowdown. However, CFF improved its margins and benefited from an increase in finance income, which led to an increase in first quarter profits by 19.7%.

We have placed a **HOLD** recommendation on the shares of CFF as we believe the stock is trading close to its fair value. We expect CFF's revenue growth rate to slow in the 2021FY, and then return to the growth rate seen in the previous three years, driven by a return to normalcy in the flavours business segment. An addition of an extra product line in hand sanitizers, as well as a rise in the demand for fragrances for sanitization products is expected to help consolidate revenues.

Company Overview

Caribbean Flavours and Fragrances Limited (CFF) was incorporated on the 23rd of February 2001 and commenced operations later in October of 2001. CFF purchased its business and assets from prior owner Bush Boake Allen Jamaica Limited ("BBA") when that entity voluntarily wound up its Jamaican operations in 2000 after 40 years in business. CFF listed on the Junior Market of the Jamaica Stock Exchange on October 2, 2013. CFF's registered office is located at 226 Spanish Town Road, Kingston 11.

The company's principal activity involves the manufacturing and distribution of flavours, mainly for the beverages, baking and confectionary industries. CFF also manufactures and distributes fragrances for general and household cleaning products, as well as for sanitation purposes.

In January of 2017, Derrimon Trading Limited (DTL) made a tender to purchase all the stocks in CFF not already held by them. This offer was accepted by the 2nd and 3rd largest shareholders at the time[1], which increased DTL's stake from 49.02% to 75.02%, resulting in CFF becoming a subsidiary of the DTL group.

CFF's 100% tax remission expired on October 2, 2018 and as consequence, the company's taxable profits will be subjected to 50% tax remission until October 2023. The company after gaining shareholder approval, had a 10:1 subdivision of the company's shares.

Financial Overview

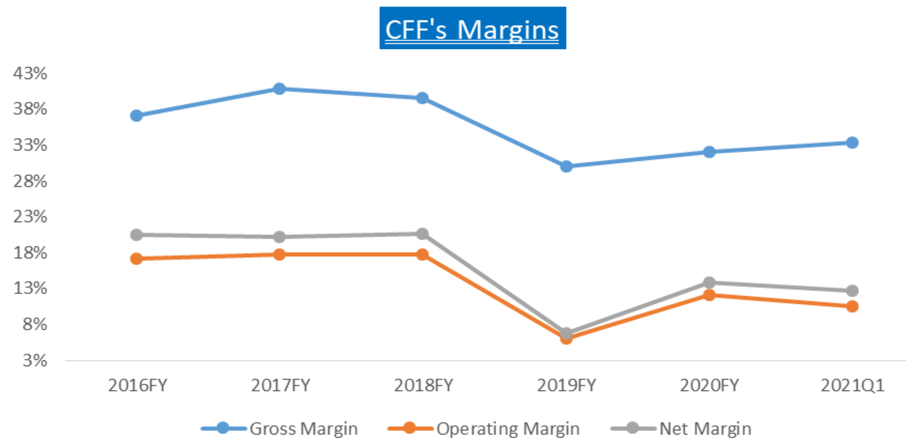
Profitability

For the 2020FY ended December 31, CFF grew revenues by 28% from $462M, to $593M. The growth in revenues for this period, outpaced CFF's 3 year compound average growth rate (CAGR) of 13%. This accelerated growth in revenues was spurred by the company capitalizing on the opportunities presented by the onset of Covid-19. CFF was able to supply an increased quantity of fragrances for cleaning and sanitation products as the pandemic resulted in a massive cleaning and sanitization drive, starting in the latter part of 1Q2020. Additional revenue was also generated from CFF developing and manufacturing its own hand sanitizer. For the 1st Quarter ended March 2021, revenues fell by 10.5% from $149M to $133.7M. Management has reported that a downturn in the local beverage market due to shortages in sugar was the main contributor to the dip in sales. A further contributing factor could be, a normalization of the growth rate of demand for sanitization related fragrances which was accelerated in the midst of the pandemic.

While cost of goods sold (COGS) increased to $407M from $323M for the 2020FY, this rate of growth was slower than the growth in revenues for the same time period, 24.7% vs 28%. This drove an improvement in CFF's gross margin, up to 32% from 30% a year prior. For the recently concluded 1st quarter, there was also an improvement in the gross margin for CFF, up to 33% from 32% despite a fall in revenue. The gross profit for this period was however lower by 7%, as

[1] The 2nd and 3rd largest shareholders were the principals of the company; Anand and Joan James.

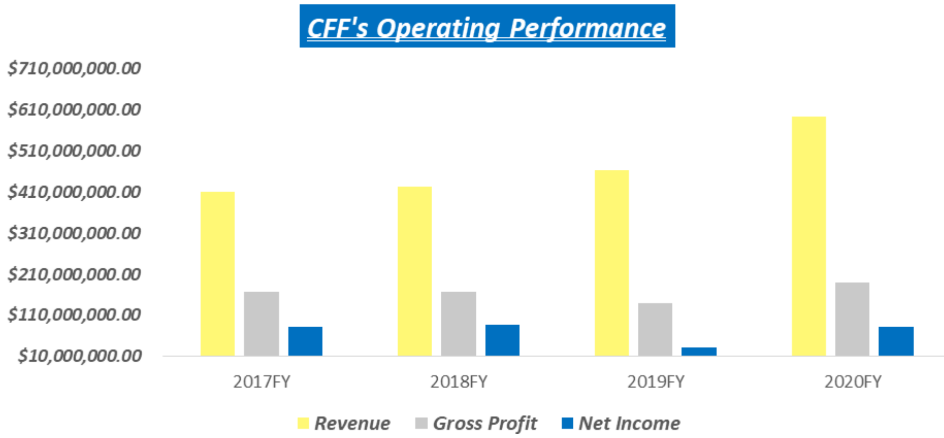
it fell to $44.5M from $47.8M for the same period last year. The gross margin for both the 2020FY and the 2021Q1 were below the 3 year average margin of 34%. Since peaking at 41% in the 2017FY, gross margin has been on a downward trend due to substantial increases in logistics costs as well as price hikes by suppliers. The margins have however begun to recover since 2020.



CFF's administrative expenses has grown at a 3-year CAGR of 9%. CFF's expense management initiatives has contributed to only a 6.7% growth in 2020; from $107.6M to $114.9M. Administrative expenses as a percentage of revenues, which has a 3-year average of 21.1%, stood 19.4% in the 2020FY. For the 2021Q1, administrative expenses actually fell by 1.2%, from $30.2M to $29.8M. The administrative expenses/revenue ratio was however slightly higher than the 3 year average, as it amounted to 22.3%.

Operating Profit has been flat over the 3 year period 2017FY to 2020FY, with one major fluctuation in-between. In 2019 operating income fell precipitously to $28M from $75M. Operating profit improved since then, climbed to $72.3M, a 157% increase. This operating profit was however marginally below the operating profit of 2017, which was $72.9M. CFF's finance income line has grown y-o-y and the majority of finance income is derived from net foreign exchange gains. CFF's also invests most of its liquid cash in short term interest bearing securities, some of which are US dollar denominated.

Net Profit for the 2020FY increased to $82.3M from $31.5M in the previous year. This was a welcome return to profitability for CFF as in 2019, the company derailed from the norm of routinely having net income surpass $80M. In the 1st quarter of 2021, a 19.1% growth in profits saw net income jumping to $16.9M from $14M. For this quarter, even though revenues were materially down, good expense management and growth in finance income, led to increased profitability.



Liquidity & Solvency

CFF has grown their asset base to $576M as at the end of 2021Q1, which represents a growth of 18.3% y-o-y as total assets stood at $486M for the same period last year. During the 2020FY, assets grew to $551.8M from $482M due to a 14.1% increase in current assets. Current assets grew to $529M from $463M in this period, as cash and cash equivalents grew by $70M y-o-y; from $225M to $295M. Current assets now stand at $554M as at the end of 1Q2021.

CFF experienced an increase in total liabilities, as at the end of 1Q2021 liabilities amounted to $137M, up 20.1% y-o-y. This growth has come about due to an increase in trade payables as well as taxation payable. CFF has very minimal interest-bearing debt. The only debt on the books of the company is a loan received in 2016, which is repayable over a 60 month period, ending August 2021. Of this loan, only $1.3M remains outstanding.

CFF remains an extremely liquid company as they have a large build-up of cash and cash equivalents, which is multiples greater than their liabilities. This is evidenced by a current ratio of 8.3x and a quick ratio of 6.2x as at the end of 2021Q1.

The equity of CFF has increased considerably over the past 3 years at a CAGR of 14%. Total equity now stands at $506.9M as at March 2021, versus $444M for the same period last year. This has resulted in a split adjusted[2] book value per share of $0.56, which is 7 cents greater than the $0.49 book value per share as at March 2020.

[2] CFF had a 10:1 stock split on October 1, 2020

Outlook & Valuation

CFF has been able to successfully maneuver the pandemic, as in this challenging time, they have been able to produce record revenue numbers. They have been able to tap into new opportunities, as they developed and sold hand sanitizers which added to the revenue base. CFF also experienced an uptick in demand for fragrances used in cleaning supplies. While the demand for both these products may begin to normalize as we slowly transition out of the pandemic, we expect that they will still contribute materially to CFF's revenue growth.

The flavor segment of the business has seen a slight downturn since the advent of Covid-19. Management has cited that the dip in its Q1 revenues was as a direct result of a downturn in Jamaica's beverage sector; leading to a decrease in demand for flavoring. CFF is hopeful that its sugar reduction substitute 'Flavour-Fit', will experience an increase demand going forward. This increase in demand would possibly stem from the gradual reopening of schools face to face, as they are subject to new guidelines for the sale of sweetened beverages. The new guidelines state that beverages sold in schools must contain no more than 4 grams of sugar per 100ml, with this possibly being reduced to 2.5 grams by 2023. CFF would benefit from manufacturers seeking to have their products fit for sale in schools, demanding a reduced sugar flavoring alternative.

We have forecasted revenues of $605M for the 2021FY. This is a 2% y-o-y increase, when compared to revenues from 2020FY. Our outlook for the remainder of the financial year is neutral and our revenue forecast factors the 10.5% fall in revenues in Q12021. We expect the beverage sector in Jamaica to return to normalcy in the summer, and throughout the rest of the year, leading to an increase in demand by beverage manufacturers. Additionally, we expect the demand for fragrances for sanitization products as well as hand sanitizers to remain significant, as persons and business continue to battle the pandemic. We have forecasted net income of $85M, owing to increased finance income in addition to growth of operating profit. Over 94% of CFF's cash and cash equivalents is invested in interest bearing assets, with 40% being US$ denominated. This would lead to increase interest income, as well as the possibility for foreign exchange gains. As per the BOJ, the annual average rate of depreciation of the J$ vis-à-vis the US$ as at March 31, 2021, stood at 8.3%.

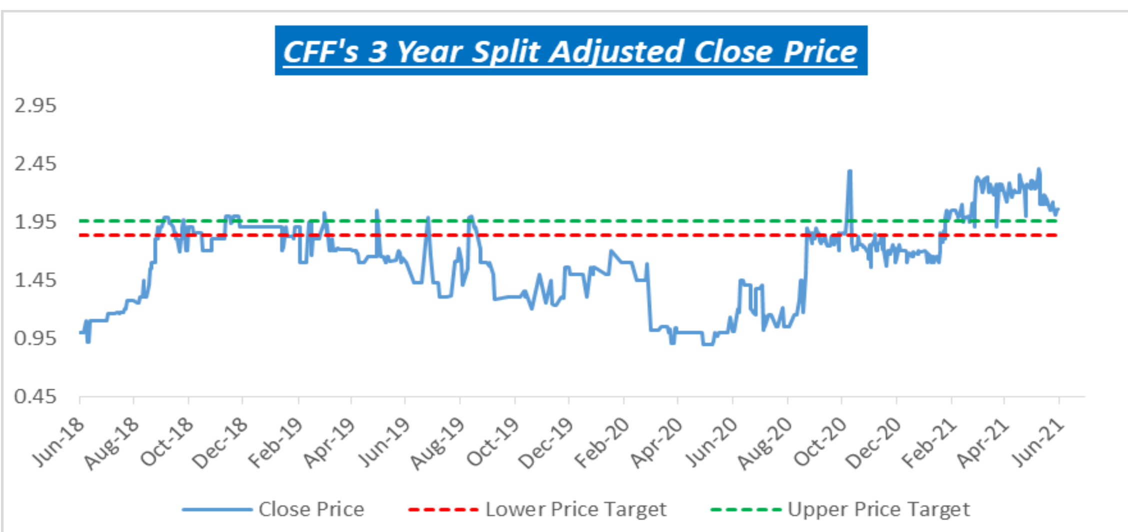
We arrived at the lower limit of our price forecast by using the free cash flow to equity (FCFE) model. The FCFE model assumed a conservative growth rate of 5.5% and a cost of equity of 10.95% resulting in a price of $1.83. Using a relative value approach, we applied the peer group trailing P/E ratio to our forecasted EPS of $0.096 for the 2021FY. This yielded a price estimate of

$1.96, the upper limit of our price forecast. **The average of our price forecasts, $1.9 is 7.8% lower than the closing price of $2.06 on June 3, 2021.**

Company	Market Capitalization	Price to Earnings	Price to Book	Return on Equity	Return on Assets
AMG	813,911,913	14.52x	1.58x	19.7%	7.0%
BPOW	2,254,310,100	23.03x	2.37x	9.5%	8.8%
HONBUN	3,185,764,582	17.14x	3.94x	21.3%	16.7%
JAMT	8,617,794,027	19.59x	3.43x	16.0%	12.8%
KREMI	2,150,266,893	22.35x	2.63x	12.4%	8.7%
LASM	23,058,264,514	16.42x	3.42x	19.2%	133.6%
PTL	2,036,056,546	63.67x	2.58x	4.1%	1.9%
PURITY	383,059,774		0.54x	-1.9%	-1.3%
Sector Average	5,312,428,544	20.56	2.74x	15.0%	10.7%
CFF	**1,843,360,677**	**21.68x**	**4.15x**	**17.90%**	**16.00%**

Key Risk to Our Price Target

CFF's ability to contain costs as well as the market's take-up of its Flavour-Fit product are essential to the company's operating profits being in-line with our forecasts. Additionally, if they are unable to achieve the level of finance income forecasted due to exchange rate fluctuations, this would have a material impact on net income. If there is a material impact on net income from the above mentioned factors, we are of the view that this may decrease the attractiveness of this stock to investors.



Recommendation

We assign a **HOLD** recommendation to CFF at this time. This asset is most suitable for equity investors with a medium to high risk tolerance. This stock currently trades marginally above our best case scenario. CFF has invested in its products and staff to be able to capitalize on opportunities presented by the pandemic as well as changes pending in the beverage sector. Despite experiencing a drop in revenues in Q1 2021, CFF was able to increase net income due to improved margins as well as an increase in finance income. The company's free cash flow has grown significantly over the past year and we expect a continuation of this growth. This could possibly lead to an increase in the entity's dividend payments.

Abridged Financials $'000								
	Year Ended June 30			Year ended December 31		Quarter Ended March 31		% Change
	2016	2017	2018	2019	2020	2020	2021	
Revenue	362,500	410,636	423,684	462,462	593,753	149,394	133,744	-10.5%
Cost of sales	(227,805)	(242,694)	(255,719)	(323,302)	(403,172)	(101,554)	(89,220)	-12.1%
Gross Profit	134,695	167,942	167,965	139,160	190,581	47,840	44,524	-6.9%
Net Income	74,070	82,877	87,206	31,500	82,299	14,217	16,937	19.1%
Total Assets	296,092	376,108	431,850	482,138	551,808	486,879	576,087	18.3%
Total Liabilities	19,741	43,248	34,390	126,843	129,192	114,189	137,170	20.1%
Shareholder's Equity	276,351	330,570	397,460	430,178	489,997	444,395	506,934	14.1%
EPS ($)	0.824	0.922	0.970	0.35	0.092*	0.016*	0.019*	19.1%
Book Value per Share ($)	3.07	3.68	0.004	4.78	.54*	0.49*	0.56*	14.1%
						*split adjusted		
Key Ratios								
Gross Margin	40.6%	41%	39.6%	30.1%	32.1%			
Net Margin	37.2%	20.2%	20.6%	6.8%	13.9%			
Return on Average Assets	25.0%	24.7%	19.1%	6.6%	15.9%			
Return on Average Equity	26.8%	27.3%	24.0%	7.4%	17.9%			
Quick Ratio (x)	11.21	7.15	10.77	5.83	6.53			
Current Ratio (x)	13.85	8.79	15.60	8.11	8.13			

Source:* *www.jamstockex.com, Bloomberg, Company Financials, Company Prospectus, JMMB Investment Research.

Your Best Interest At Heart. Full Stop.

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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STRONGLY UNDERPERFORM—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 2.5% FOR THIS PARTICULAR ASSET

UNDERPERFORM—REDUCE EXPOSURE IN YOUR PORTFOLIO TO 2.5% - 4.9% FOR THIS PARTICULAR ASSET

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

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

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

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