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GraceKennedy Limited

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Executive Summary

GraceKennedy Limited (GK) was founded in February 1922 and is currently listed on the Jamaica Stock Exchange and the Trinidad & Tobago Stock Exchange. GK has two primary divisions: **Food Trading** and **Financial Services**. The Financial Services division is further divided into three segments Banking & Investments, Insurance and Money Services.

Food Trading (GK Foods) operations include retail outlets, food manufacturing and distribution of Grace and Grace-owned brands locally and internationally. In addition, GK Foods has subsidiaries in several countries, including Jamaica, Central America, North America, Africa, the United Kingdom, and several European countries. Meanwhile, the Financial Services division operates in commercial banking, general insurance, health insurance, creditor life insurance, insurance brokerage, investment banking, remittance, cambio and payment services business. **The majority of FY 2021 revenue was generated in three geographic locations, namely Jamaica (53.6%), North America (19.6%) and Europe, including the UK (13.1%).**

GK currently trades at approximately 13.1x, its trailing 12-months EPS above the 11.7x harmonic mean of the peer group. Meanwhile, GK has relatively high liquidity, exchanging an average daily volume of 252.6 thousand units over the past year, valued at approximately $25.6 million. Over the past month, GK has had an average bid-ask spread of about 1.5%, indicating a relatively low implicit cost to trade shares.

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Recent Developments

For the 1st quarter ended March 2022, revenue rose 15.5% to $36.3 billion. Meanwhile, profits attributable to GK shareholders increased by 4.9% to $1.7 billion. The primary driver of the revenue growth was the Food Trading segment, which experienced an 18.1% improvement in revenue to $29.5 billion. Additionally, the Insurance segment external revenue increased by 16.2% to $2.8 billion. However, the Money Services segment hindered revenue growth, which fell 8.6% to $2.1 billion.

A 25.9% decline in operating results at the Money Services segment to $801.9 million hindered profitability growth. The decline in revenue and operating results from the Money Services segment was due to lower remittance flows and foreign currency volatility in the quarter. However, operating results from the Banking & Investment and Insurance segments grew by 207.3% and 124.4% to $391.5 million and $203.2 million, respectively, cushioned some of the losses experienced.

Key Financial Data

	YE 2017	YE 2018	YE 2019	YE 2020	YE 2021	CAGR	Q1 2021	Q1 2022	Change
BVPS	45.46	44.84	52.60	60.22	67.95	10.57%	62.89	68.83	9.45%
EPS	4.14	5.03	4.51	6.25	8.23	18.77%	1.66	1.75	4.94%
Dividend per share	1.32	1.35	1.55	1.59	1.92	9.89%	-	-	N/A
Adj. Close Price	43.84	63.50	69.43	62.68	100.02	22.90%	87.64	103.90	18.55%
JSE Main Market Index	288,382	379,791	509,916	395,615	396,156	8.26%	394,660	391,232	-0.87%
Abridged Income Statement (in Billions)									
Revenue	92.48	97.54	103.09	115.44	129.31	8.74%	31.39	36.26	15.49%
Operating Profit	5.62	6.63	6.26	9.83	11.90	20.64%	2.37	2.45	3.57%
Other Income	2.09	3.49	2.52	3.02	4.61	21.87%	0.84	0.90	6.88%
Share of Profit from Associated Company	0.48	0.49	0.52	0.54	0.41	-3.83%	0.29	0.32	13.57%
Pre-tax Profit	5.82	6.96	6.13	9.71	11.68	19.02%	2.52	2.57	2.14%
Profits	4.12	5.01	4.49	6.22	8.19	18.77%	1.65	1.74	4.94%
Abridged Balance Sheet (in Billions)									
Cash and Deposits	12.08	14.82	14.63	24.33	30.04	25.56%	26.49	29.12	9.92%
Investment Securities	31.85	28.26	30.67	33.51	40.48	6.17%	35.40	38.59	9.02%
Total Assets	129.99	135.24	154.71	171.70	199.80	11.35%	178.64	202.00	13.08%
Total Liabilities	82.98	88.55	99.99	108.92	128.79	11.62%	112.86	129.98	15.16%
Debt	16.52	16.53	24.03	25.23	27.99	14.10%	25.10	28.76	14.60%
Equity	45.22	44.61	52.33	59.91	67.61	10.57%	62.57	68.48	9.45%
Abridged Cash Flow Statement (in Billions)									
CFO	(0.49)	9.44	7.05	13.88	17.07	N/A	2.29	(1.94)	-184.74%
CFI	(0.94)	(4.30)	(2.31)	(0.71)	(9.64)	79.12%	0.29	0.76	162.08%
CFF	0.57	(2.28)	(3.36)	(4.24)	(3.62)	N/A	(1.05)	(0.73)	-30.74%
Ratios						Average			
Operating Margin	6.08%	6.79%	6.07%	8.51%	9.20%	7.33%	7.54%	6.76%	-10.32%
Net Profit Margin	4.45%	5.13%	4.35%	5.39%	6.33%	5.13%	5.27%	4.79%	-9.14%
Debt-to Equity	0.365	0.370	0.459	0.421	0.414	0.406	0.401	0.420	4.71%
Financial Leverage	2.88	2.94	3.01	2.94	2.91	2.94	2.91	2.93	0.71%
ROE	9.43%	11.14%	9.26%	11.08%	12.85%	10.75%	11.39%	12.63%	10.83%
ROA	3.21%	3.77%	3.10%	3.81%	4.41%	3.66%	3.88%	4.35%	11.97%
P/E	10.60	12.62	15.40	10.03	12.15	12.16	13.30	12.50	-6.06%
P/B	0.96	1.42	1.32	1.04	1.47	1.24	1.39	1.51	8.32%
Dividend Payout Ratio	31.85%	26.76%	34.30%	25.50%	23.34%	28.35%	0.00%	0.00%	N/A
Dividend Yield	3.15%	2.59%	2.41%	2.64%	2.09%	2.57%	0.00%	0.00%	N/A

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Financial Overview

Income Statement Review

Revenue surged 12% in FY 2021 to a record of $129.3 billion. The growth in GK revenue was aided by the Money Services segment, generating revenue growth of 20.2%. Furthermore, all GK's revenue generating segments grew in FY 2021. GK's primary revenue-generating segment is Food Trading which produced 78.5% of FY 2021 revenues. Revenue growth from the Food Trading segment has benefited from higher at-home consumption rates. Meanwhile, GK's insurance segment remains the second-largest source of revenue, generating 8.7%. Meanwhile, Jamaica's share of GK's revenue marginally decreased from 55.4% to 53.6% in FY 2021 due to sales in North America only increasing by 6.9% in FY 2021.

GK's primary sources of operating income in 2021 are Food Trading and Money Services, which generate 47.7% (2020: 42.4%) and 34.3% (2020: 40.3%) of operating results, respectively, in FY 2021. The change in operating income mix is due to operating results from the food trading segment surging 35% to $5.7 billion versus only a 2% increase in the Money Services segment to $4.1 billion.

Balance Sheet Review

Total Assets have increased at a CAGR of 11.4% for the period under review to $199.8 billion. While in FY 2021, total assets increased by 16.4% due in part to a 23.5% increase in Cash & Deposits to $30 billion, and Investment Securities increased by 20.8% to $40.5 billion.

Cash & Deposits constituents are cash at the bank & in hand of $24.1 billion (2020: $17.3 billion) and deposits of $5.9 billion (2020: $7 billion). The weighted average effective interest rate on deposits was 3.29% in FY 2021, marginally lower than the 3.35% recorded in FY 2020. **However, given the increase in interest rates, the effective rate on deposits may increase in the near term.**

The primary classification for investment securities is investment securities recorded at amortised cost of $37.8 billion (2020: $29.9 billion). Furthermore, only $746.6 million (2020: $541.5 million) is considered fair value through profit or loss. **Therefore the impact of market fluctuation on asset prices on net income is limited under normal circumstances.**

Meanwhile, total liabilities increased 18.3% to $128.8 billion at the end of FY 2021. The increase in liabilities is primarily due to increased deposits and payables, which increased by 15.7% and 27.7% to $48.1 billion and $36 billion (2020: $28.2 billion).

The primary contributor to payables is insurance reserves of $10.8 billion (2020: $9.5 billion). The primary driver of the payables increase was a 69.2% surge in trade payables to $9.3 billion (2020: $5.5 billion). **Reducing the current payables levels could negatively impact operating cash flow in the near term**.

Cash Flow Statement Review

Cash flow from operating activities reached a peak of $17.1 billion in FY 2021. The increase in payables by $7.1 billion aided FY 2021 cash flow strength. Therefore reducing payables could hinder operating cash flows in the near term.

The primary source of cash outflow from financing activities is the repayment of debt of $18.6 billion (2020: $11.7 billion); however, this is largely matched by the $18.5 billion (2020: $11.7 billion) in loans received. Loan refinancing is a significant part of annual operating cash outflow; this could be an issue as increased interest rates could result in higher finance expenses for the Company. A substantial contributor to cash outflows from financing activities is dividend payments which increased to $1.9 billion (2020: $1.6 billion). GK has a track record of consistently growing its dividend payments, and therefore investors can expect at least $1.9 billion of dividends in FY 2022.

Ratios Review

The operating profit margin peaked in FY 2021 at 9.2%, well above the five year average of 7.3%. However, in Q1 FY 2022 operating margin fell to 6.8%. The decline was due to falling margins in the Food Trading and Money Services segment. Logistics issues, including delays in the supply chain and port congestion, negatively impacted the Food Trading segment. Meanwhile, lower remittance flows and foreign currency volatility negatively impacted the Money Services segment.

GK's debt-to-equity has declined to 0.41x in FY 2021, down from 0.46x in FY 2019, due to IFRS 16 adoption. More recently, debt to equity has ticked up marginally to 0.42x at the end of Q1 FY 2022. However, GK still has ample room to use debt and its current cash resources to drive acquisitions.

DuPont analysis reveals that the ROE growth in FY 2021 was driven by profit margin expansion, given that total asset turnover and financial leverage declined.

Forecast and Valuation

We used our projection of GK's FY 2022 EPS and BVPS and then applied the harmonic mean P/E and P/B multiple of peers (adjusted for historical differences) to arrive at our price target of $88.38. Inherent in our price target is the assumption that investor sentiment towards GK's peer group remains relatively stable. Below is a chart illustrating the relationship between GK's P/E and P/B ratio and its peer group average over the last three years. **We used the 90th and 10th percentile of P/B and the P/E valuation difference to derive the upper and lower price targets of $108.52 and $68.93, respectively.**

Chart 1 below indicates that GK's P/E is trading below the upper end of historical levels of a 19.8% premium compared to the peer group average. However, GK's current P/E premium to the peer group average of 12% indicates significant downside risk given that, usually, GK trades at a 2.42% discount to the peer group average. However, GK's P/E ratio relative to peers has, on average, seen a material improvement since early 2021, possibly due to increased positive sentiment given the profit growth seen in FY 2020 and FY 2021.

Meanwhile, Chart 2 indicates that the current P/B premium of 8.5% at which GK trades relative to peers is well above 6.8%, the upper end of historical levels and significantly above the discount of 13% experienced on average over the past three years. However, since late 2021 GK's P/B ratio has traded mainly at a premium to peers, which indicates a material shift in sentiment towards GK.

The strength of GK's recent results and news of acquisitions is likely the primary driver of the increased positive sentiment towards GK relative to peers. However, given our expectation for earnings to decline in FY 2022, we expect some of the optimistic views to fade.

Chart 1.

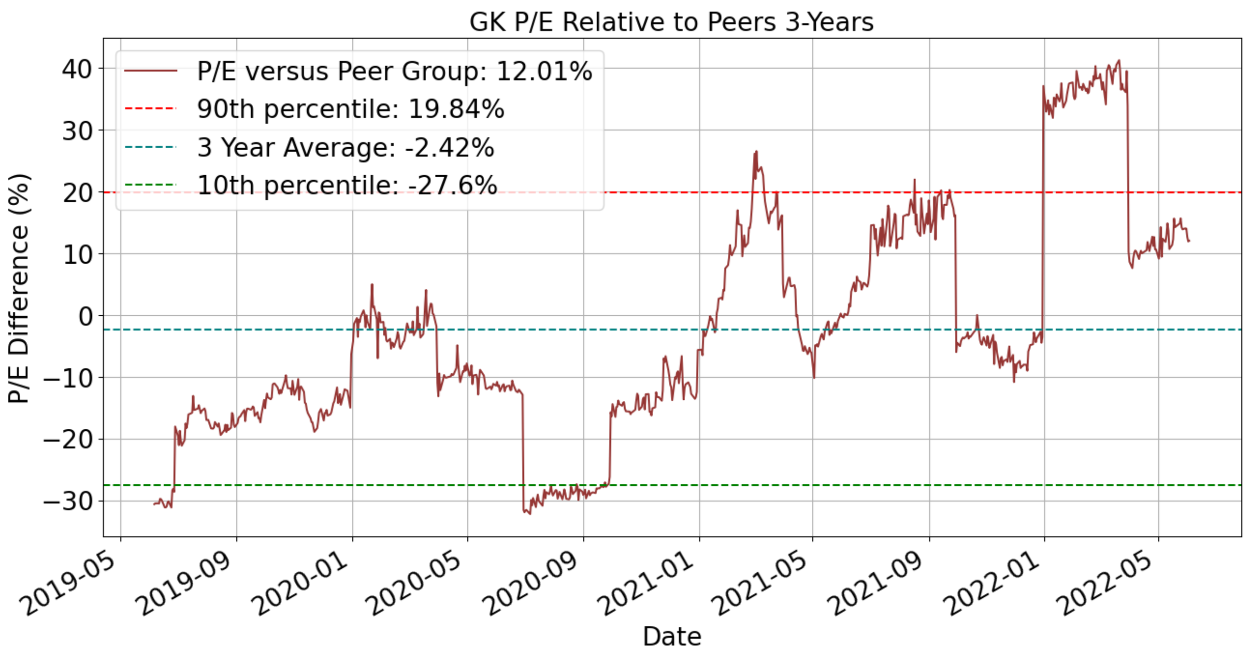

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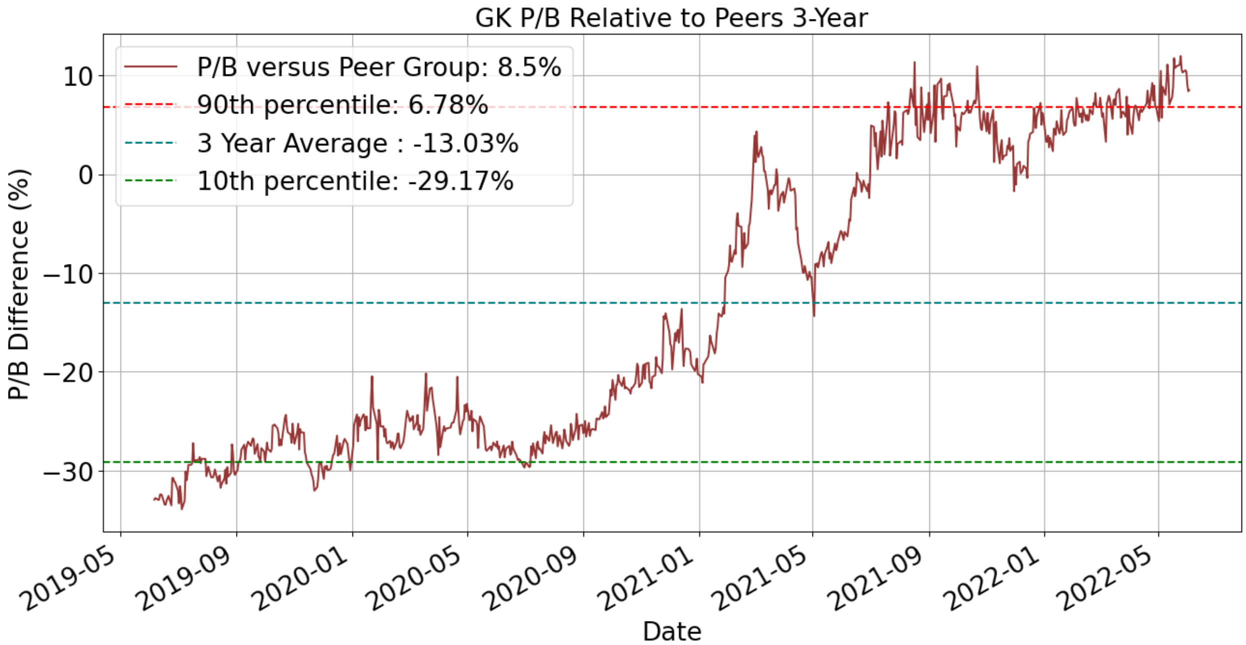
Chart 2.



Large Cap. Conglomerates					
Ticker	**Market Cap($B)**	**P/E**	**P/B**	**ROA**	**ROE**
GK	108.32	13.09	1.58	4.35%	12.63%
JP	25.53	12.80	1.40	4.60%	11.53%
PJAM	71.09	9.80	1.41	11.26%	14.87%
H Mean	68.31	11.70	1.46	6.73%	13.01%

Outlook

We expect acquisitions such as GK's increased 10% stake in CSGK Finance Holding and Scotia Insurance Eastern Limited to bode well for earnings growth. Furthermore, new product offerings, including GK's entry into the mutual fund market, will further aid long-term earnings growth.

We expect increased rates on GK's deposits to aid net interest income growth. However, given GK's current debt levels, the rising interest rate environment could negatively affect GK's net interest income. Furthermore, the decline in revenue and PBT in the Money Services segment in Q1 FY 2022 may challenge earnings growth in FY 2022.

Lower operating profit from the Money Services segment, other income and increased interest expense drive our expectation for a decline in FY 2022 earnings. These factors resulted in our forecast for the earnings shown in the table below.

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FY	Q1	Q2	Q3	Q4	YE
2022	1.75	E 1.74	E 1.93	E 1.95	E 7.36
2021	1.66	1.94	2.10	2.53	8.23

Key Risks to Our Price Target

The main risks to our price target are a decrease in profitability at GK Money Services (GKMS) and a mean reversion of operating margins at the Food Trading segment. **GKMS is a pivotal contributor to operating profit; therefore, failure to continue growing due to increased competition could impact GK's growth potential**. The growth in GKMS operating results was primarily due to efficiency increases, which significantly increased operating margins relative to historical levels. Our forecast expects the Company to maintain strong margins at the Food Trading and GKMS; however, GK could fail to meet our price target if unable to do so.

Recommendation:

We are maintaining our UNDERWEIGHT recommendation on GK, given that it trades in line with our upper price target. Our rating considers several factors, including the Company's balance sheet quality, GK's stock price relative to our price targets and stock liquidity.

GK has $30 billion and $40.5 billion of cash and deposits and investment securities, respectively, while having $28 billion of debt. Therefore its ability to meet debt obligations is reasonably high. Meanwhile, the Company has maintained a debt-to-equity ratio that has been relatively stable, averaging 0.41x for the five years ended 2021. Furthermore, GK has produced strong operating cash flow since FY 2018, reaching a high of $17.1 billion in FY 2021.

Meanwhile, GK has shown steady earnings growth for the period under review, with earnings surging 31.7% in FY 2021. Earnings growth was due to revenue growth and margin expansion, with some one-off gain. In addition, the FY 2021 growth allowed the Company to reward shareholders with dividend payments of $1.9 billion ($1.93 per share), marginally higher than FY 2020's payment.

GK has increased 8.9% YTD, significantly outperforming the JSE Main Market decline of about 1.9% for the same period. Finally, GK's stock is among the most liquid listed entities, trading an average daily value of approximately $25.6 million over the last year. **See charts 3 – 5 below for volume and value exchanged annually for the period under review and GK's YTD performance.**

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Chart 3.

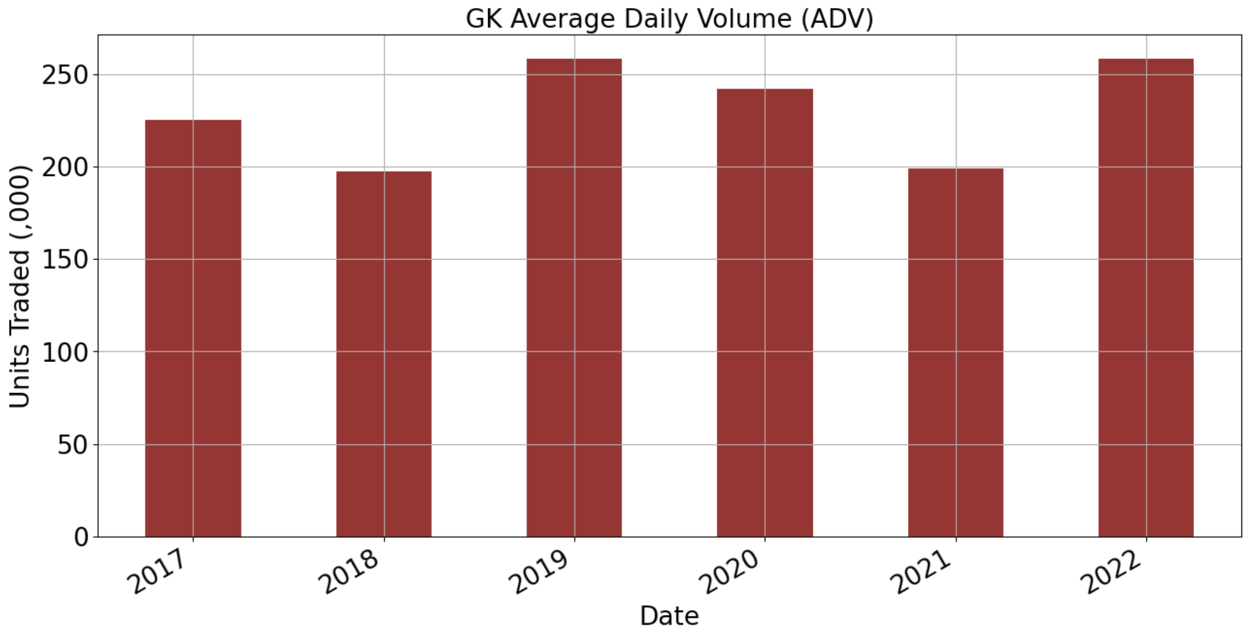

Chart 4

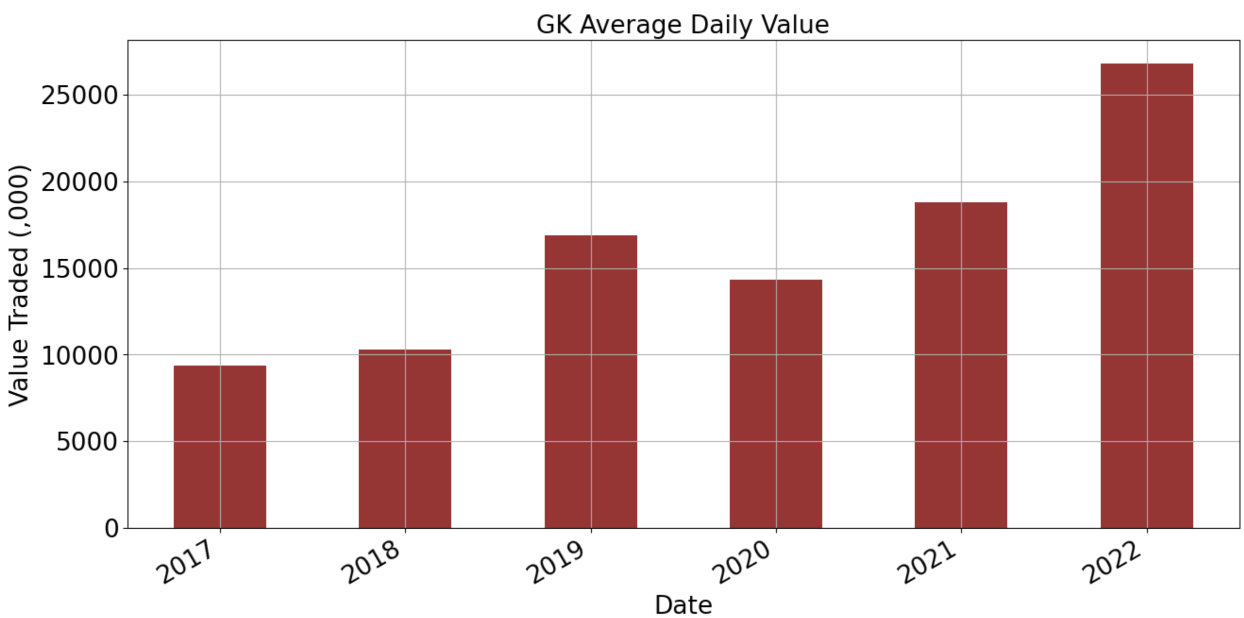

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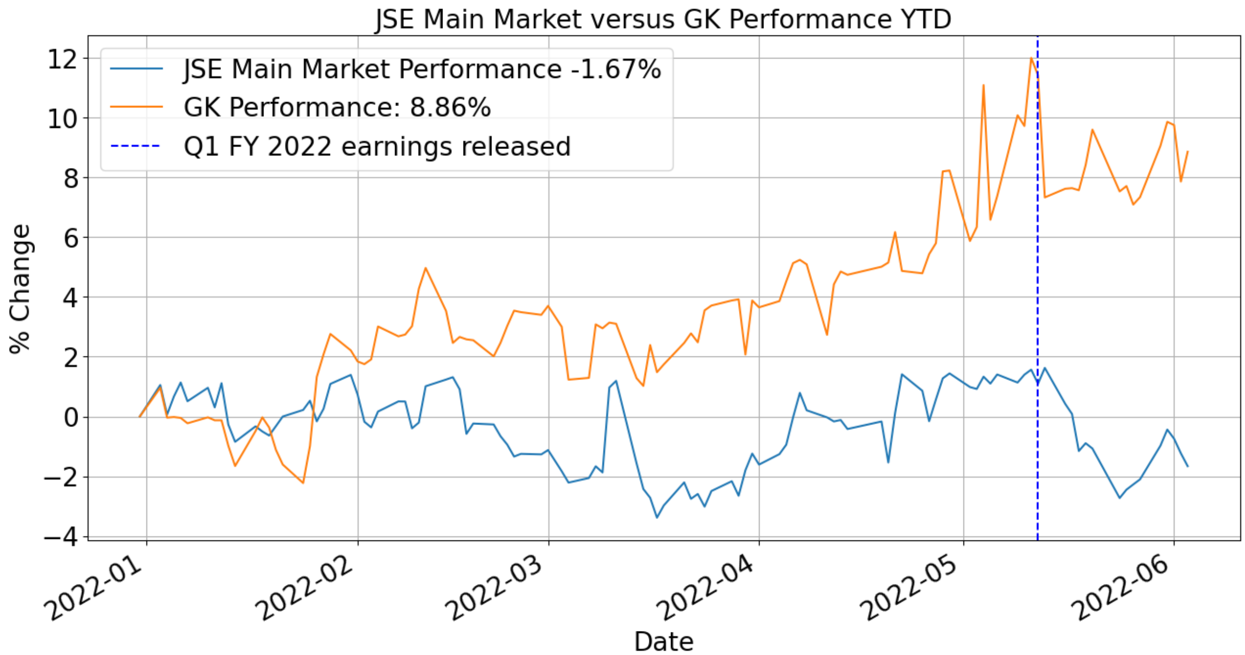
Chart 5.



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

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.

OUTPERFORM/OVERWEIGHT/BUY—EXPOSURE TO THIS ASSET SHOULD BE UP TO 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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

UNDERPERFORM/UNDERWEIGHT— ADJUST EXPOSURE IN YOUR PORTFOLIO HELD AT JMMB TO BETWEEN 2.5% AND 4.9% FOR THIS PARTICULAR ASSET

STRONGLY UNDERPERFORM/UNDERWEIGHT—REDUCE EXPOSURE TO THIS ASSET TO BELOW 2.5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO (0%).

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