July-6-2022

JMMB INVESTMENT & SOVEREIGN RESEARCH

Seprod Limited (SEP)

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EXECUTIVE SUMMARY

Seprod Limited (SEP) is a leading Jamaican manufacturing, agribusiness and distribution company. The Company maintains large positions in the Jamaican market for several products including edible oils and fats, milk and sweetened condensed milk. In addition, it owns many consumer brands such as Betty, Butterkist, Chef, Chiffon, Cool Fruit, Gold Seal, Golden Grove, Lider, Miracle, Serge, Supligen and Swizzle. Seprod was found in 1944 and was listed on the Jamaica Stock Exchange in 1985.

Over the past 3 years, SEP has grown revenues by a Compound Annual Growth Rate (CAGR) of 24.9% while growing net income by a CAGR of 23.4%. Over the 12-month period ended December 2021, SEP has grown revenues to $43.88B, a 16.3% increase over the 2020YE revenues of $37.73B. SEP has also grown profits to $595.2M for the quarter ended March 2022, compared to profits of $546.3M for the corresponding three months period in 2021.

SEP's Price Movement

SEP's Statistics

Financial Year End		December
Stock Price (25/05/2022)	$	70.55
EPS	$	2.72
Book Value per share	$	31.97
P/E		23.83x
P/B		2.03x
Net Profit FY2021 (millions)	$	1,993
Price Target	$	77.40
Dividend Yield		2.0%

We have placed a **HOLD/MARKETPERFORM** recommendation on the shares of SEP, as we believe the stock is trading close to its fair value. Over the past few years, Seprod has made several moves, which have begun to bear fruit and has taken the decision to discontinue its failed venture in sugar manufacturing, which generated billions in losses over the years. The entity is susceptible to adverse economic conditions, this includes rising inflation driven by higher global commodity and freight costs and the resurgence of the coronavirus (COVID-19) pandemic. Nevertheless, SEP's future earnings should improve, on the basis that strategies continue to be implemented by management to expand and diversify distribution reach to improve revenue, contain cost and improve profitability margins.

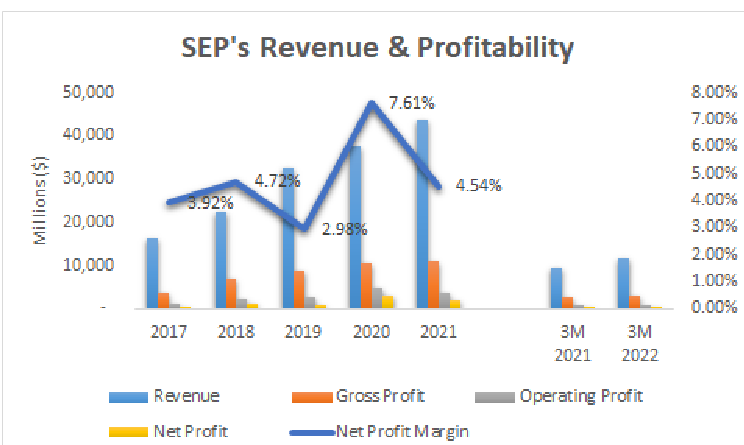
Company Background

Seprod Limited was incorporated in Jamaica in July 1940 and became a publicly-listed company in 1985. Seprod now operates with three business lines: Ingredients, Dairy and Distribution. The Ingredients division consists of Seprod's joint venture with Seaboard Corporation, Jamaica Grain and Cereals Limited, which commenced flour production in December 2017. The operation also produces cornmeal and grits in bulk as well as consumer-size packages. In 2019, the company divested its sugar manufacturing operation after racking up significant losses over the years after acknowledging the sectors significant structural inefficiencies.

The Dairy line has been expanded with the integration of the dairy operation formerly owned and operated by the Nestle Group. The operation includes the physical assets based in Bog Walk, St. Catherine and the "Betty" and "Supligen" brands. The acquisition of Facey Consumer forms the foundation of the Distribution arm of Seprod.

Financial Overview

Profitability



For the period FY2018 - FY2021, the compound average growth rate (CAGR) of Seprod's revenues was 24.94%. Revenues totalled $43.88B for the 2021FY, up 16.3% from the year prior or $6.15B while direct expenses were up 28.4% to $32.97B. Direct expenses grew faster than revenues, which resulted in a decline in the gross profit margin to 24.9% from 27.8%. Gross profits amounted to $10.9B, up 4.1% year-over-year. Management highlighted that while the average cost of goods has risen by approximately 20% compounded by significant increase in working capital requirement to acquire the higher cost inputs and to ensure adequate stock availability to meet customers demand, the company has absorbed some of the higher costs, which resulted in margin compression. For the quarter ended March 2022, direct expenses increased from $6.89B to $8.87B due to higher commodity prices and ongoing supply chain challenges. SEP noted that the cost of key raw and packaging materials are at 10-year high levels and currently show very little sign of retreating.

Finance and other operating income fell by 39% to $1.52B; selling expense fell by 12.6% to $410.43M, while administrative expenses grew 7.8% to $8.4B. Notably, the decrease in 'finance and other operating income' was driven by a 99% decrease in 'Gain on disposal of property, plant and equipment', due to a one-off gain from the sale of a Marcus Garvey Drive property which amounted to $753.94M in FY2020. As a result, Seprod reported an operating profit of $3.6B for the 2021FY, which was down 23% year-over-year. However, for the three months ended March 2022, operating profit increased year over year from $945.16M to $996.83M, mainly attributable to the rise in revenue.

Pre-tax profits amounted to $2.31B, down 32.2% year-over-year, as the fire at Facey Merchandise's distribution centre resulted in a loss of $168.18M. Notably, finance costs fell 5.3% to $1.19B. Total net profit amounted to $1.99B, down 30.6% year-over-year. The pre-tax profit margin fell from 9.04% to 5.27% year-over-year while the net profit margin stood at 4.54%, down from 7.61% for the prior year. The return on assets stood at 5.69%, compared to 10.18% a year prior while the return on equity stood at 8.50%, relative to 17% in 2020. More recent, net income increased to $595.21M for the three months period ending March 2022, up from $546.31M for the corresponding three months period in 2021. This increase in net income was attributable to several factors, which includes an increase in revenue and cost containment measures.

Liquidity & Solvency

As at December 31, 2021, Seprod's total assets amounted to $46.91B, a 23.2% or $8.83B increase, year-over-year. Non-current assets amounted to $27.74B, a 31.82% increase year-over-year while current assets amounted to $19.18B, up 12.54% from the prior year's balance. The increase in non-current assets was driven by the booking of $13.93B in Property Plant and Equipment; and a 92% increase in long-term receivables to $1.38B. Additionally, investment in joint venture rose by 55.3% from $448.83M the prior year to $697.06M as at the 2021FY.

The increase in current assets was driven by a 35% rise in inventories to $10.21B and a 17.3% rise in trade and other receivables to $6.47B. This increase was partially offset by a 40.8% decline in cash and bank balances to $1.65B. Seprod also booked $285.76M in "non-current assets held for sale" which represents the carrying value of assets associated with the discontinued sugar manufacturing operations that are currently for sale. Notably, the discontinued sugar operations continues to depress Seprod's earnings with a $145.83M loss booked for the 2021FY.

Total liabilities amounted to $23.46B, a 10.7% or $2.28B increase year-over-year. Non-current liabilities rose 2.5% to $11.59B, while current liabilities grew by 20.2% to $11.88B. The increase in non-current liabilities was mainly driven by a 35.4% increase in deferred tax liabilities to $2.05B. The increase in current liabilities was driven by a 47.4% increase in payables to $8.45B.

The company's liquidity position deteriorated for the FY2022, due to the increase in current liabilities. The company's current ratio for the period under review was 1.61x, a decrease from a ratio of 1.72x in 2020. Moreover, the quick ratio and cash ratio fell to 0.75x and 0.14x respectively.

Total debt amounted to $12.50B and was down 4.3% year-over-year. Seprod's leverage as measured by the debt-to-equity ratio stood at 0.53x, down from 0.77x. Seprod's ability to service its debt obligations, as represented by the interest coverage ratio, deteriorated but remained sufficient. The interest coverage ratio moved from 3.70x to 3.00x for the 2021FY. Shareholders' equity amounted to $23.45B, up 38.8% year-over-year as capital reserves surged to $6.70B from $1.18B the prior year, which is attributable to fair value gains on property of $5.46B reported as at the 2021 FY. Notably, retained earnings rose by 10.5% to $10.98B.

Cash Flow Adequacy

Cash from operating activities (CFO) represented inflows of $2.68B for the twelve-month period, relative to inflows of $3.19B in 2020. The deterioration in CFO was mainly driven by the increase in cash used for the increase in inventories.

Cash from investing activities represented an outflow of $1.07B for FY2021, relative to an outflow of $828.13M in FY2020. The purchase of PPE was the primary outflow from investing activities, amounting to $1.65B.

Cash from financing activities represented an outflow of $2.89B for the period, relative to an outflow of $1.11B in 2021. This was mainly driven by the increase in long-term loans repaid and dividends paid, which amounted to $3.86B and $953.61M respectively.

Outlook & Valuation

The Bank of Jamaica (BOJ) recently further tightened monetary policy by increasing the policy interest rate by 50 basis points (bps) to 5.5% per cent per annum, effective 30th June 2022. The Bank's decisions aim to continue limiting the pass-through of the ongoing and protracted commodity price shock to inflation and facilitate a return of inflation to the target range over the shortest possible time period. Notably, the pace of economic recovery in Jamaica and the global economy in the March 2022 quarter has been hampered by high inflation, continued supply chain disruptions and a resurgence of the coronavirus (COVID-19) pandemic. The uncertainty arising from the invasion of Ukraine by Russia continued to influence a rise in international commodity prices, which has added to further increases in domestic inflation and inflation expectations.

Commodity prices surged during the first quarter of 2022, reflecting the effects of the war in Ukraine as well as continued growth in demand and various constraints on supply. Amid concerns about the war's disruptive effects on commodity supply, the increases in prices were particularly pronounced for commodities where Russia and Ukraine are large exporters, particularly energy, fertilizers, and some grains and metals. These developments have added to a broad-based rise in commodity prices that began in mid-2020 with a surge in demand driven by prolong concerns about the COVID-19 pandemic.

Moreover, Sepord's management highlighted that the cost of key raw and packaging materials are at ten-year highs and shows very little signs of retreating. As such, we anticipate that Seprod would continue to absorb higher costs related to ongoing commodity price increases and supply chain challenges, which is likely to increase cost of raw materials and dampen the company's profitability margins.

Nevertheless, the Jamaican economy has begun to show signs of recovery in the service industry, recording a growth of 7.4% in Q4 2021. We anticipate a recovery in the tourism industry, albeit cautious of the COVID-19 cases and vaccination rate. This assumption was formed based on the projected growth in Hotels & Restaurants and Other Services, which reflects the continued improvement from the travel industry as the number of flights coming into the island continues to increase, given the low COVID-19 positivity rate. As such, Seprod should realize an improvement in the demand for its products from the tourism industry and increase the company's revenue. In addition, the re-opening of schools is likely to improve the demand for Seprod's products, given the low COVID-19 positivity rate.

Seprod is still generating expenses from the discontinuation of the sugar operation, booking a loss of approximately $146M for the 2021FY. Additionally, the company has 3,500 acres of cane land under lease, resulting in a lease cost of US$100,000 in 2021. However, management highlighted their intention to convert the sugar cane crop to cattle feed. Notably, Seprod has signed a letter of intent with un-named interested parties that will allow for the use of the factory facilities in agro-processing. We anticipate that this strategy to invest in agro-processing and produce cattle feed, will assist to alleviate the company's cost of sales, especially with the rising cost of imported animal feed and fertilizers.

Over the past few years, Seprod has made several moves, which have begun to bear fruit. In addition to the acquisition of Facey Consumer in 2018, Seprod formerly acquired direct ownership of diary assets from its largest shareholder – Musson Jamaica, which acquired it from Nestle Jamaica in 2016. Seprod also formed a joint venture company, Jamaica Grain and Cereals Limited, with Seaboard Corporation and commenced flour production in December 2017. More recently, Seprod came to an agreement to acquire A.S. Bryden & Sons Holdings ("A.S. Bryden") in 2022, a 100 year-old Trinidad & Tobago company.

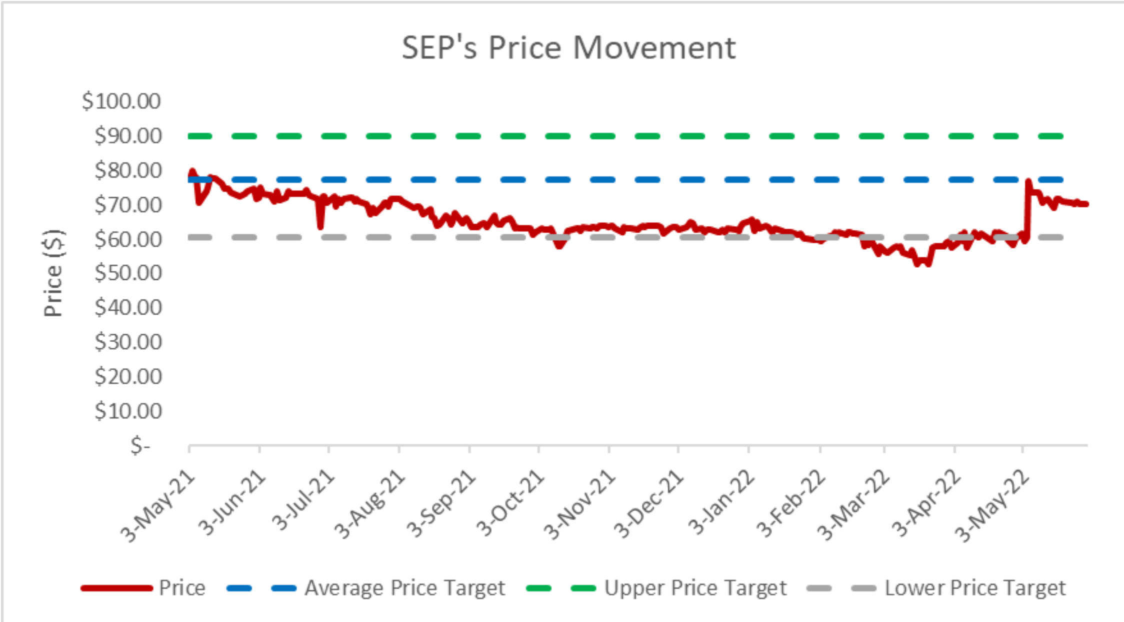
A.S. Bryden distributes food, pharmaceuticals, hardware, houseware and industrial equipment. Notably, Seprod's acquisition of the Trinidad based A.S. Bryden, provides gateways to both the Guyana and Barbados markets. One of the A.S. Bryden subsidiaries, Bryden pi through its wholly owned subsidiary Genethics, operates in Guyana through its subsidiary BPI Guyana and in Barbados through its joint venture Armstrong Healthcare Inc. Limited. Therefore, this acquisition is expected to develop Seprod's regional footprint throughout the Caribbean and is likely to expand and diversify Seprod's distribution reach and drive export sales.

Over a four-year period (2017-2021), there has been a consistent improvement in SEP's revenue generation, growing at CAGR of 27.7%. Notably, Seprod has seen resilience in the demand for its goods as it sells many products that fall under the "Consumer Staples" category. Consumer staples are essential products that include typical products such as food & beverage, household goods, pharmaceutical drugs and hygiene products. Consumer staples are viewed as non-cyclical as they represent goods that consumers are unable, or unwilling to cut from their budgets regardless of their financial situation. This attribute makes consumer staples least affected by changes in business cycles as consumers demand these goods at a relatively constant price.

Based on these assumptions, we arrived at our price target of $78.34 using the Discounted Cash Flow (DCF) model. Meanwhile using the DCF under two additional scenarios produced our upper and lower case price targets of $90.03 and $60.57 respectively. The primary difference between the scenarios is the trajectory of interest rates, inflationary pressures, economic growth, global commodity prices, supply chain challenges, another wave of the corona virus and the impact it has on the tourism industry, among other industries. The best-case scenario assumes lower inflationary pressures, stable interest rates to facilitate expansion of projects in the pipeline and acquisitions, lower global commodity prices and freight cost, an improvement in global supply chain which will likely lower cost of sales and improve the availability of products. Meanwhile, we looked at a different scenario with revenue generation deteriorating and increase in cost. This assumption is based on the rise in global commodity prices and ongoing supply chain issues, which will likely result in an increase in the final price of products and another wave of the corona virus resulting in disruption in business operations and a fall in demand of Seprod's products, particularly from the tourism industry due to travel restrictions.

	Price Target		Implied Upside/Downside
Upper	$	90.03	28%
Base	$	77.40	10%
Lower	$	60.57	-14%

Additionally, we applied our forward EPS to the 1-year average PE ratio of 25.96x, which provide an intrinsic value of $76.46. **Averaging these forecasts gives us a price target of $77.40, which is 9.71% higher than Seprod's recent closing price of $70.55.**



Recommendation

We recommend Seprod Limited as MARKETPERFORM/HOLD as our estimate of the fair value is line with the current market value. The stock is suitable for investors with a long-term investment horizon and a low to medium risk appetite given Seprod's position as market leader in manufacturing and distribution and proven ability to withstand economic cycles.

Abridged Financials	2017	2018	2019	2020	2021	Change	THREE MONTHS Mar-21	Mar-22	Change
Revenue	16,511,206	22,499,784	32,694,821	37,737,080	43,883,405	16.3%	9,578,975	11,808,382	23.27%
Cost of Sales	(12,687,358)	(15,585,707)	(23,894,709)	(27,252,457)	(32,972,098)	21.0%	(6,896,862)	(8,872,309)	28.6%
Gross Profit	3,823,848	6,914,077	8,800,112	10,484,623	10,911,307	4.1%	2,682,113	2,936,073	9.5%
Operating Profit	1,330,969	2,482,280	2,802,635	4,681,143	3,599,483	-23.1%	945,159	996,831	5.5%
Net Profit	647,843	1,062,055	973,334	2,871,916	1,993,421	-30.6%	546,307	595,208	9.0%
Total Assets	20,008,056	35,298,364	36,498,540	38,079,974	46,911,644	23.2%	38,081,536	45,785,150	20.2%
Total Liabilities	10,998,244	20,552,742	21,528,303	21,186,947	23,462,740	10.7%	20,806,146	21,721,967	4.4%
Total Shareholder's Equity	9,009,812	14,745,622	14,970,237	16,893,027	23,448,904	38.8%	17,275,390	24,063,183	39.3%
EPS ($)	1.42	2.06	1.46	3.92	2.72		0.74	0.81	
Book Value per share ($)	12.28	20.10	20.41	23.03	31.97		23.55	32.80	
Key Ratios									
Gross Profit margin	23.2%	30.7%	26.9%	27.8%	24.9%		28.0%	24.9%	
Operating Profit Margin	8.1%	11.0%	8.6%	12.4%	8.2%		9.9%	8.4%	
Net Profit margin	3.9%	4.7%	3.0%	7.6%	4.5%		5.7%	5.0%	
Return on Assets	3.2%	3.0%	2.7%	7.5%	4.2%		1.4%	1.3%	
Return on Equity	7.2%	7.2%	6.5%	17.0%	8.5%		3.2%	2.5%	
Current ratio (x)	1.30	1.71	1.94	1.72	1.61		1.77	1.77	
Quick ratio (x)	1.02	0.94	1.01	0.96	0.75		1.12	0.87	
Cash ratio (x)	0.09	0.24	0.20	0.28	0.14		0.33	0.11	
Debt/Equity (x)	0.41	0.84	0.82	0.77	0.53		0.75	0.55	

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

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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