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LOCAL EQUITY REPORT

SEPROD LIMITED

Barita Investments Limited
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Company Overview

Seprod is one of the largest food manufacturing and distribution companies in the English-speaking Caribbean. In the last three years, the company has grown considerably on the back of strategic improvements aimed at broadening its scope and increasing operational efficiency. This transformation was led by CEO, Richard Pandohie, former President of the Jamaica Manufacturers and Exporters Association. Since becoming CEO, Mr. Pandohie has made several changes that have benefited the Group's bottom line immensely. Seprod manufactures and distributes household food and beverage products, much of which are also offered online.

Stock	SEP
Close Price	J$63.53
Estimated Fair Value	J$77.40
Potential Upside	**21.83%**
Dividend Yield	1.26%
Total Return	**23.09%**
Year to Date Return	-2.11%
Trailing P/E	16.72x
Recommendation	**OVERWEIGHT**
September 10, 2021	

Executive Summary

Seprod Limited was incorporated in July 1940 to produce soap and edible products. Through strategic planning, company acquisitions, market responsiveness, product diversification to meet the needs of local and international clientele, as well as strong local and export marketing, the company has grown to include several subsidiaries and is positioned among the largest in the food manufacturing and distribution sector locally. Since 2018, the Group has targeted growth primarily through the acquisition of the Facey Consumer Division and large-scale infrastructure development to streamline its manufacturing and distribution process. In FY2019, the Group added targeted cost reduction to its strategic goal, the chief decision in that regard, was the discontinuation of its loss-making sugar business. As such, the 2019 decisions were painful but a necessary process, marked by material earnings decrease despite strong top-line growth. In 2020, however, the strategic decisions of the years past paid off and the company saw a material improvement in its financial performance. Notwithstanding, since the start of the 2021 financial year, net profit has declined, in large part due to global factors that have driven higher raw material costs.

Seprod intends to continue investing in infrastructure projects to broaden its scope as it relates to both the manufacturing and distribution processes. This will allow the company to continue serving the Jamaican market while also broadening its international reach.

Analyst Outlook

As indicated in the executive summary, Seprod has been transformed to become a more efficient and profitable entity following several restructuring and expansion efforts. In FY2021, however, profitability has somewhat waned, owing to global inflationary pressures driven by pandemic-induced supply chain constraints. Specifically, as demand has rebounded due to the ongoing vaccine administration globally, supply (largely commodities) has not kept pace and in some cases, supply chain disruptions due to COVID-19 case surges have stopped/slowed the flow of goods, a highly inflationary factor. Essentially, the current above-trend inflation for both commodities and the cost of shipping is driven by COVID-19 related dislocations. Consequently, an improvement in effective vaccination efforts globally should support a slowing of current price increases which we have seen since the start of the September 2021 quarter.

Notwithstanding, the pandemic has unearthed some drawbacks of relying completely on raw materials from varying countries and as such, some nations have begun to consider reshoring and nearshoring, with a somewhat soft "de-globalization" stance. With that said, while more widespread vaccination efforts should slow the rapid increase in prices we've seen earlier this year, reshoring and other structural changes in global supply chains may present lingering issues that can affect the pricing of raw materials. In our view, however, the run-up in price that we've seen thus far is unprecedented, but the main driver, i.e., the pandemic, is broadly becoming less challenging each day as companies and nations adapt. With that said, we're of the view that extreme price increases could slow further over the near term, but given structural changes, price levels may remain elevated for some time.
These price pressures on raw materials can be navigated through improved partnerships, product price increases, bolstering lower cost inventories, reducing operational costs, establishing new supply routes, etc. Thus far, Seprod has reduced operational costs to stem the effect of heightened gross costs (mainly raw material + shipping) and we expect these efforts will continue to be employed

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to manage the effects of global inflation. Notwithstanding the continued efficiency of the company outside the international effects of global prices, the stock price has declined. Upon adjusting for the weaker performance over the near term driven by heightened costs while considering a positive long-term outlook, we believe the stock is currently undervalued and recommend an **OVERWEIGHT**.

Business Positioning

The company operates in two main segments, **Manufacturing** and **Distribution**. The Manufacturing segment covers the company's manufacturing and sale of oils and fats, corn and wheat products, cereals, milk products, juices, and biscuits. The Distribution segment covers consumer goods.

Within the context of the COVID-19 pandemic, Seprod reported that its operations were negatively impacted. Notwithstanding, the Group has seen significant improvement in revenues. Specifically, the pharmaceuticals aspect of its business did well and since a lot of the products in its portfolio are basic products that consumers want to buy, as indicated by CEO, Richard Pandohie, Seprod was able to improve on the previous year's performance in 2020. Some of these include portfolio brands like Gold Seal flour, consumer foods Eve, Geddes, and NuPak, and a range of milk products, juices, and biscuits.

Strategic Positioning

On January 1, 2018, 100% of the share capital of Musson Holdings Limited (MHL) and its wholly-owned subsidiaries were transferred from a related entity. Additionally, on October 1, 2018, Seprod completed a major acquisition of Facey Commodities Holding Limited (FCHL) and its wholly-owned subsidiary Facey Commodity Company Limited.

Since these acquisitions, Seprod has largely been in a growth phase which has made the Group significantly larger relative to 3 years prior. At present, the company is still in the process of fully integrating and streamlining processes post-acquisition and we expect continued improvement in cost efficiencies. This can be credited to the company's CEO who has made significant operational changes to enhance the company's capacity to deliver quality goods in Jamaica and abroad while delivering solid returns for shareholders. Going into 2020, the company's investment in operational growth and efficiency thus far include the following:

- **Facey Consumer Division:** The acquisition of the Facey Consumer Division in 2018 had the immediate effect of a 53% increase in revenue in Q4 2018 and significantly increased the range of the company's products and brands.
- **Nestle:** The transfer of the former Jamaican dairy operations of Nestle to Seprod.
- **Sugar Operations:** The discontinuation of the sugar business which has been making losses over the last decade - Seprod's CEO, Richard Pandohie, noted that if the company hadn't decided to exit the business, Seprod would have been chalking up yearly losses of $400 million.
- **Infrastructure Expansion:** The acquisition of property adjacent to its head office as a means towards further expansion of its warehousing and distribution capacity by building a 50,000 sqft warehouse.
- **Dairy Processing Consolidation:** In 2019, Seprod merged its two dairy processing operations (Serge Island and MIDL) to become "Serge Dairies." This has resulted in a best-in-class facility that has significant volumes driving the profitability of the business. The closure and subsequent consolidation was a necessary decision which the company expects will yield material positive results. The consolidation represents the culmination of a $J7 billion investment over the last five years. Essentially, it positions Seprod to grow the dairy business exponentially through innovation and exports fueled by aggressive growth targets.

The culmination of these changes has resulted in a more efficient business which shows in the Group's 2020 financial performance which improved significantly despite the pandemic.

Financial Performance (6 months ended June 2021)

Income Statement

Revenue: For the 6 months ended June 2021, Seprod reported revenue of $19.83 billion, relative to $18.61 billion in the prior year, reflecting an increase of $1.22 billion (6.57%). This revenue improvement suggests that demand for the Company's products remain anchored, despite the progression of the pandemic.

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Gross Profit: For the period, gross profit amounted to $5.44 billion, a decline of $1.07 (16.42%) over the prior year's $6.51 billion. The Company's cost of goods sold has climbed YoY by $2.29 billion (18.94%), moving the cost of sales as a percentage of revenue from 65.00% in FY2020 to 72.55% in FY2021. This increase in the cost of goods sold and consequent decline in gross profit has been driven by global supply chain challenges which have negatively impacted the following, as reported by Seprod:

- **The availability and cost of raw and packaging materials.** Some key commodities have increased more than 100%.
- **Shipping cost, especially out of Asia,** which have increased more than 500% and continues to climb.
- **The working capital requirement has also increased,** driven by higher prices and by the fact that, where possible, Seprod is carrying more inventory to militate against stockouts from worsening supply chain disruptions.

Operating Profit and Finance Cost: In light of these external cost pressures associated with the pandemic, Seprod has increased its cost management through its operating expenses, which has cushioned the Group's profitability. Specifically, operating expenses YTD are down by $885.18 million (19.64%) YoY. This has strengthened operating profit but was not sufficient to result in a YoY increase, given the magnitude of the cost of sales growth coupled with one-off gains from the prior year of approximately $762 million from the sale of property. For the period, operating profit amounted to $2.00 billion, down from $2.22 billion in the previous year, a decline of $222.99 million (10.03%). Finance costs also decline by $ 94.20 million (15.83%) YoY, owing to lower long-term debt obligations.

Profit Before Tax and Taxation: Profit before tax for the period was $1.53 billion, a YoY decline of $101.53 million (6.22%). The effective tax rate for the period improved, moving from 19.35% in the previous year to 18.71% in the current period.

Net Profit: YTD, net profit from continuing operations amounted to $1.21 billion, a decline of $93.49 million (7.19%). Notably, while it has declined, this marks an improvement over the previous quarter's (Q1'21) net profit decline of -12.46%, which the Company credits to the realignment of its cost structure and price increases in Q2. Net profit inclusive of discontinued operations totalled $546.31 million, a decline of $86.41 million (13.66%).

The culmination of these factors related to international shipping indicates that profitability and operating cash flow generation will be strained once these factors persist.

Balance Sheet

As at June 30, 2021, Seprod reported **total assets** of $39.13 billion relative to $36.45 billion in the prior year, representing a YoY increase of approximately $2.68 billion (7.36%) in the company's asset base. This increase largely reflects the company’s increased inventory on hand totalled $7.84 billion relative to $6.27 billion in the prior year, an increase of $1.57 billion (25.06%) as well as growth in receivables which amounted to $6.44 billion relative to $5.73 billion in the prior year, an increase of $708.76 million (12.36%). The growth in inventory reflects Seprod's indication of increasing inventory as a means of mitigating further supply chain issues while growth in receivables could be a consequence of buyers increasing purchases given expectations of continued inflationary pressures.

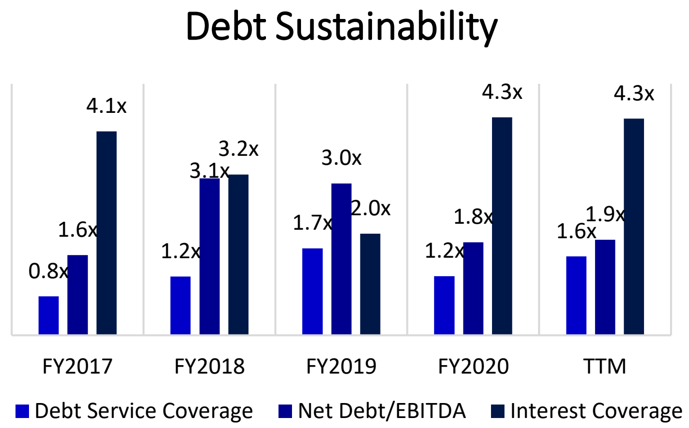
The Company's funding is driven predominantly by **liabilities** which amounted to $21.17 billion compared to $20.08 billion in the prior year, an increase of $1.09 billion (5.45%). Growth in liabilities YoY was driven predominantly by increased payables (+$747.98 million or 15.66%). **Total Equities** for the period amounted to $17.96 billion, a YoY increase of $1.59 billion (9.71%) which was largely due to increased retained earnings which amounted to $10.93 billion (+$1.52 billion YoY or 16.16%).

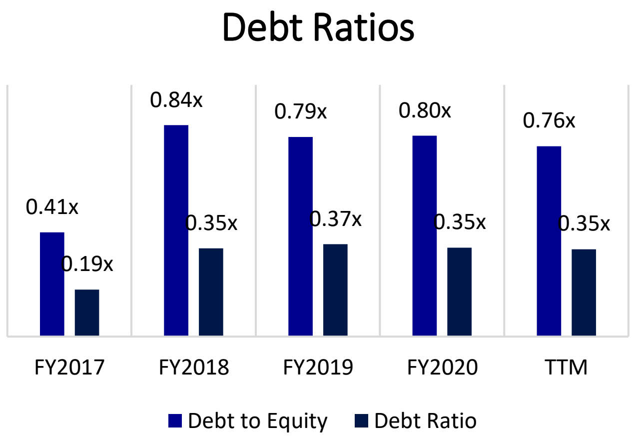
Liquidity and Solvency

Solvency and Debt Coverage

The Group’s leverage grew by more than three-folds in FY2018 relative to FY2017 which was largely due to the acquisition of the Facey Consumer Division. Notwithstanding, the company’s leverage position remained well within a reasonable level as demonstrated by its debt to equity and debt ratios which amounted to 0.80x and 0.35x, respectively in FY2018. Thereafter, debt has to equity has trended down with a TTM outturn of 0.76x.

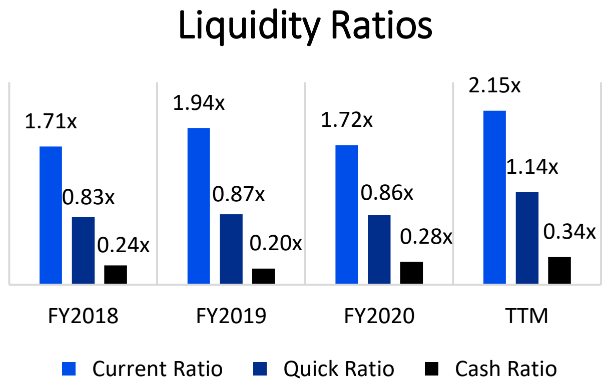
As it relates to coverage, despite the increases in costs that have reduced Group profitability over the period, both debt and interest coverage ratios remain in line with and better than pre-pandemic ratios, depending on the specific year.

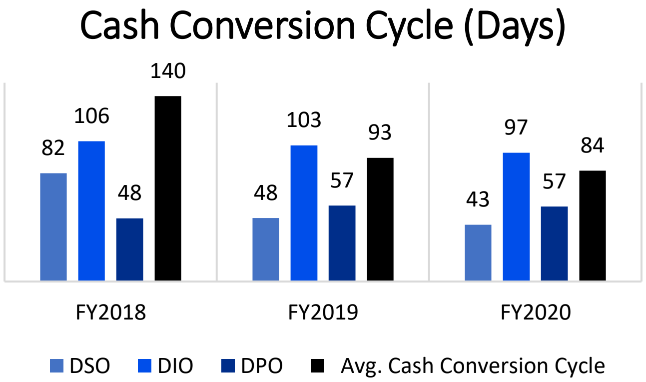




Liquidity

Seprod's liquidity has generally been sufficient as indicated by the company's current ratio which has averaged 1.88x between FY2018 and the most recent 6 months 2021 report. Notably, the company reported a reduction in its liquidity ratios in FY2020. This reduction reflects an increase in the company's total current liabilities as a large portion of its debt ($3.66 billion) was due within the next 12 months. We anticipate that part of the funding for this upcoming debt will be facilitated through operating cash flows and another portion through additional debt given the company's current cash balance is less than the amount due, at $2.79 billion. As we look at cash conversion, up to FY2020, Seprod was improving its cash conversion each year, as indicated by its cash conversion cycle of 84 days in FY2020 relative to 140 days in FY2018.

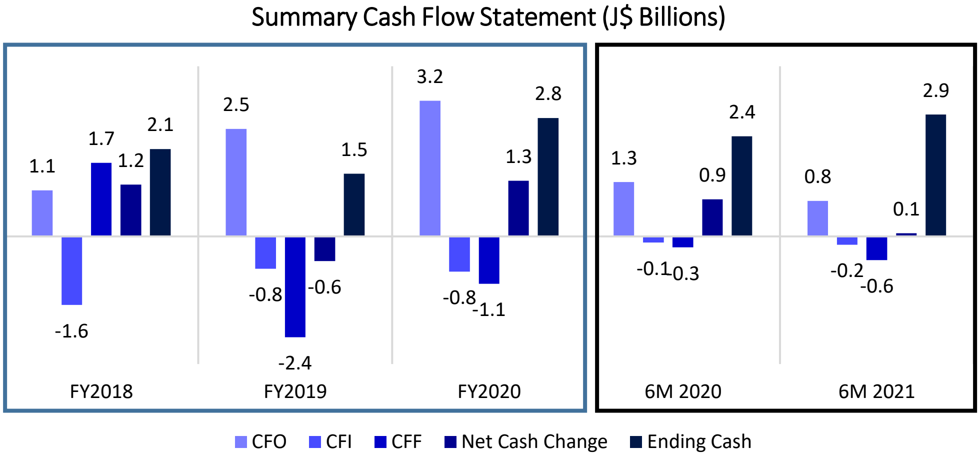




Noteworthy, given the intention of the company to increase inventory and the recent increase in receivables, the cash conversion cycle is expected to increase (worsen) in FY2021. Notwithstanding, liquidity ratios are expected to remain above pre-pandemic levels given the increase in current assets. Finally, while we expect cash generation to slow, Seprod remains a high cash-generating business that should support continued working capital management.

Cash Flow

Seprod's cash flow from operations has been strong over the last three years, growing from $1.08 billion in FY2018 to $3.19 billion in FY2020. In FY2020, the company added $1.24 billion to its cash balance (not accounting for currency translation gains). Adjusting for the added debt received in the year indicates that the company's cash balance increased organically (without the use of debt) by $541.56 million in FY2020.
In FY2021, operating cash flow is expected to be negatively affected by working capital changes as inventories are increased to stay ahead of rising prices. We also expect receivables to remain elevated as consumers buy on credit to also avoid expected price increases. To date, the working capital positioning of the Company has already deteriorated. Specifically, operating cash flow before working capital amounted to $2.52 billion relative to $2.61 billion in the prior year, just a slight decline of $87.13 million (3.34%). However, the change in working capital for the period has amounted to an outflow of $1.42 billion, much larger than the prior year's outflow of $987.65 million. Consequently, net operating cash flow for the period has amounted to $835.28 million, a YoY decline of $440.75 million (34.54%).



Growth Expectations

At its meetings on August 17 and 18, 2021, the Bank of Jamaica noted that recent significant increases in international commodity prices will cause inflation in Jamaica to temporarily breach the upper limit of the Bank's target range from as early as the September 2021 quarter. We anticipate that these rising costs internationally will affect raw material costs for Seprod as has been the case since the start of the year and should therefore continue to weigh on profit growth.

It's important to note, however, that the heightened inflation that we've witnessed internationally has largely been due to increased supply chain issues wherein the rebound in demand has outpaced supply. In some cases, the pandemic continues to create disruptions that have limited and temporarily halted the shipment of goods which has created upward price pressures as demand remained anchored. Additionally, increased demand and a shortage of supply have increased the cost of commodities which broadly reflect the cost of raw materials for many companies. These price increases underlie the increase in cost of sales that Seprod has reported since FY2021.

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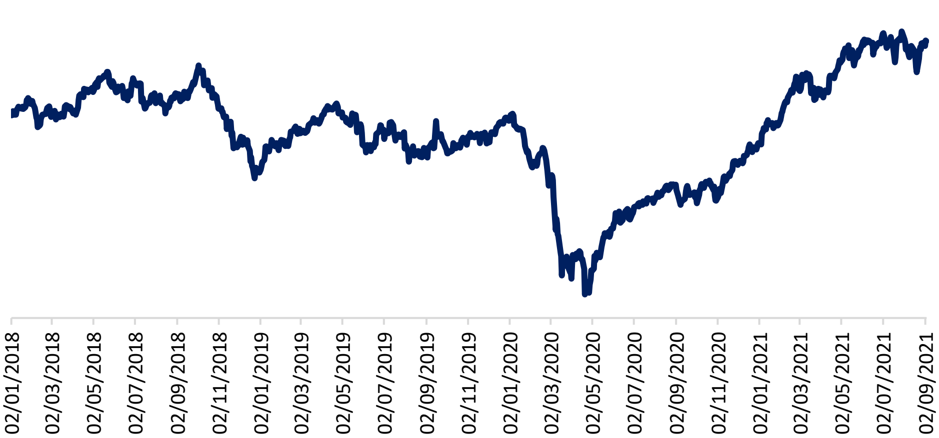
S&P GSCI



Source: *Bloomberg*

2020		2021	
Nov to Dec	6.19%	July to Aug	-2.54%
Oct to Nov	13.15%	June to July	0.96%
Sep to Oct	-2.68%	May to June	3.23%
Aug to Sep	-2.24%	April to June	2.64%
July to Aug	5.41%	Mar to April	8.22%
June to July	4.41%	Feb to Mar	-2.01%
May to June	5.99%	Jan to Feb	10.67%
April to May	19.46%	Dec to Jan	5.26%
March to April	0.59%		
Feb to March	-28.71%		
Jan to Feb	-7.81%		

Source: *Bloomberg*

Commodity Prices

The S&P Goldman Sachs Commodity Index (S&P GSCI) is typically recognized as the leading measure of commodity prices. As indicated in the chart, commodity prices have increased exponentially (115.23%) since the pandemic and have surpassed pre-pandemic levels since February 2021. Notwithstanding the uptrend, the table to the right of the chart details the monthly increase in the index. It demonstrates that over the most recent quarter beginning in the "June to July" period, the rate of change in the index has slowed relative to earlier this year.

Notably, between the start of the year and August 2021, the index has grown by 28.80%. As shown in the table, the largest increases throughout this period were recorded in earlier months. From January 29 to February 26 ("Jan to Feb" in the table), for example, the index grew by 10.67%. January to March represents the first quarter, during which the index rose 14.15%. April to June represents the second quarter which grew by 5.95% and June to August represents two-thirds of the third quarter and during this period, there's been a decline of 1.61%, largely representing the July 30 to August 31 period which, as per the table, recorded a decline of 2.54%.

Essentially, what this demonstrates is that during the current September quarter, while commodity prices remain elevated, the pace of the price increase has broadly been slowing and in some cases, declining. This suggests that from the perspective of manufacturers like Seprod, the cost of raw materials, though still high, now has a greater level of predictability. This may improve the planning process for the company which is important in a period of heightened uncertainty.

Shipping Costs

Similar to commodity price increases, the price of shipping has increased exponentially, growing by as much as 3.05x since the start of 2021 as measured by the **Freightos Baltic Index (FBX): Global Container Freight Index**. As reported by the Independent Commodity Intelligence Services (ICIS), supply chain issues are broadly expected to remain this year as many businesses are operating with limited inventory. As shown in the inventory to sales ratio chart below, inventory to sales remains subdued relative to the pre-pandemic period which suggests that a continued reopening of the economy would potentially drive increased demand for goods which could drive prices higher as the current supply of goods relative to sales is low. Notwithstanding, similar to commodity prices, the pace of the increase in shipping costs has slowed over the September quarter.

We believe prices should remain elevated for both commodities and shipping costs as low inventories are coupled with stronger demand. Notwithstanding, in the most recent September quarter, the pace of the increase in prices has slowed which is a near-

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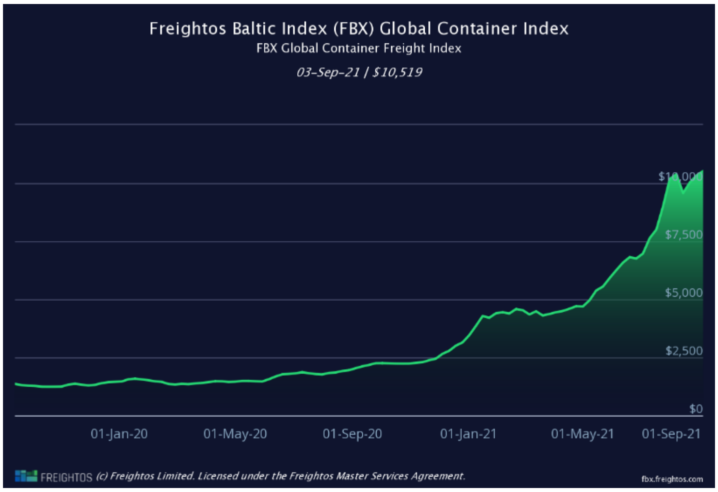
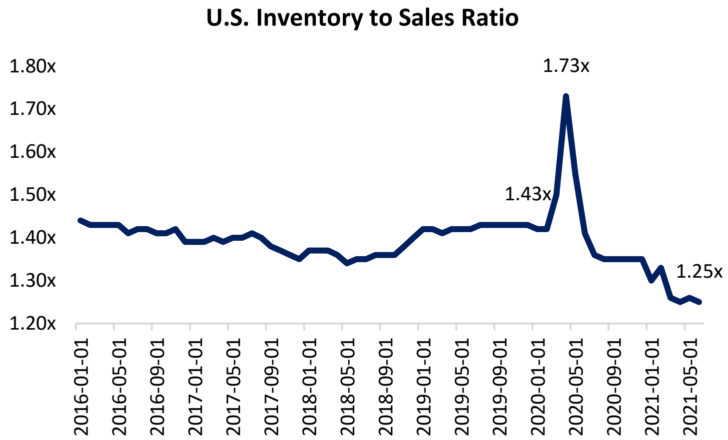
term positive outturn. Over the long term, we believe demand and supply imbalances should correct which would benefit manufactures like Seprod from a further slowing of commodity and shipping cost growth. In our view, the potential exists that longer-term structural changes such as reshoring and nearshoring may affect the price of goods long term but the main driver remains the pandemic and we are cautiously optimistic that the worst of it, from a global economic perspective, has passed.



Source: *Freightos Baltic Index*



Source: *Federal Reserve Economic Data*

New Developments

Logistics Campus: The first tranche of $1 billion has already been spent on new warehousing space at the rear of the Seprod plant at Marcus Garvey Drive in Kingston's industrial belt. Another $1 billion of financing is currently in hand to continue the development of the logistics hub, which, once complete, will provide for water harvesting and will use photovoltaic or solar energy to power the operations. This in addition to a 95,000-square-foot warehouse, brings the total to 200,000 square feet of space for Seprod's logistics center. With this new facility and an expanded distribution fleet of delivery trucks, Seprod intends to target some 8000 brick-and-mortar customers.

Further Consolidations: the focus will be to improve distribution, warehousing and logistics efforts. The company intends to consolidate warehousing operations and create a distribution organization that will be cost-competitive. The project commenced in 2019 with the first warehouse completed and Industrial Sales Limited (one of Seprod's distribution companies) being relocated to Felix Fox Boulevard.

In our view, these developments indicate a continued posture towards growth initiatives. While the pandemic causes direct cost issues, this is a global event that not only affects Seprod but many other companies internationally that rely on the global supply chain. To the extent that these factors dissipate over time, we believe Seprod remains very well positioned as a Company to deliver considerable growth.

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Valuation Summary

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To value Seprod, we utilized a Price to Earnings and a Free Cash Flow Valuation.

Price to Earnings Valuation

In our price-to-earnings valuation, we estimated YoY revenue growth of 8.2% in the first year followed by 12.3% in the following year. In the last two quarters, Q1 2021 and Q2 2021, revenue growth has slowed to 4.8% and 8.2%, respectively. We've forecasted that after a year, revenue growth will return to the Twelve Trailing Months (TTM) level of 12.3%, up from the most recent 8.2% but still below FY2020's outturn of 15.4%. Our two-year forecast of net profit from continuing operations is $2.91 billion, reflecting a net profit margin of 6.64%, equating to FY2020 NPM after adjusting for one-off gains. Consequently, we arrived at a two-year EPS estimate of $$3.96. At present, the market is pricing Seprod at a P/E of 16.72x. However, normalizing indicates the stock is being priced at a P/E of approximately 23.05x. We've utilized the average P/E of comparable listed companies to arrive at a market multiple of 19.02x. Utilizing this multiple resulted in a target price of $75.32.

Free Cash Flow Valuation

In our 5-year free cash flow to firm model, we assumed the same revenue growth rate in year 1 and year 2, after which growth is steadily decreased to our estimate of long-term growth (7.18%) based on the company's average retention ratio and ROE in FY2018 and FY2019. We estimate an operating profit margin of 10.81% over the next year. Thereafter, the operating profit margin is increased by 1.33% annually to account for the expected improvement in working capital and operational efficiency. To arrive at free cash flow, we reduce the company's net operating profit after tax by our estimate of reinvestment based on the company's sales to capital ratio of 1.36x. We estimate a WACC of 10.99%, resulting in a firm value of $69.17 billion. This is adjusted for total debt and cash to arrive at the company's equity value of $58.29 billion or $79.48 per share.

By averaging both valuations, we arrived at a price target of $77.40 which represents an upside of 21.83% and a total return of 23.09%. Given the upside potential of the stock, we recommend an OVERWEIGHT.

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