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LOCAL EQUITY REPORT

FONTANA LIMITED

Barita Investments Limited
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Company Overview

Fontana Limited is a public company listed on the Junior Market of the Jamaica Stock Exchange that has been in operation for the past 54 years, having been founded by Bobby and Angela Chang in 1968 with its first outlet at the Manchester Shopping Centre. The Company is now a fairly large private pharmacy chain in Jamaica with six (6) outlets. The founder of Fontana conceptualized the name of the Company with the use of a fountain located nearby and playing on the words of his sixth child, Anne, who is now the Executive Director and Chief Executive Officer (CEO) of the firm. Its core operations revolve around the sale of pharmaceutical products, but the Company also offers retail products spanning housewares, beauty and cosmetics, home décor, toys, electronics, souvenirs, and other products. The Company has outlined that in addition to its large size and market share, a major competitive advantage is its customer service made possible through its human capital.

Stock	FONTANA
Close Price	J$10.05
Estimated Fair Value	**J$10.36**
YTD Return	29.79%
Trailing PE	23.76x
Forward PE	20.53x
Dividend Yield	3.18%
Potential Upside	**3.03%**
Total Return	**6.22%**
Recommendation	**MARKETWEIGHT**
as at March 25, 2022	

Investment Rationale

Fontana's operations are broad and inclusive, as indicated by the Company's distribution network that is bolstered by its six (6) strategically placed outlets in densely populated areas of the island. In keeping with this model of strategic outlet locations, the Company is expected to open a seventh pharmacy in Portmore, St. Catherine. Given the non-cyclical nature of the Company's main products, pharmaceuticals, despite the pandemic, Fontana managed to reach $5 billion in revenue during its financial year ended June 2021, a historic high for the Company. A large contributor to the growth of the Company was the opening of its Waterloo branch in November 2019. Management has outlined plans to open a new branch in Portmore by late 2022 or early 2023. Consequently, the Company's outlook is supported by its plan to capitalize on having a branch in one of Jamaica's most populated areas. From a macro perspective, the Planning Institute of Jamaica (PIOJ) reported that for the September to December 2021 quarter, the projected real value-added for retail & wholesale trade was 9.6%. Compared to the prior period's -8.8%, this shows a 209% increase in output. With the bulk of the pandemic hopefully behind us and the near-complete removal of restrictions, there is optimism that the Company will continue to drive growth organically. With face-to-face classes being reinstated, for instance, demand for more school-related items could provide additional support for revenue generation in Q3 and beyond.

The Company outlined at the end of its financial year that its focus will be on staff retention, training, driving operational efficiencies, containing costs, and growth. The Company believes that they are well-positioned to withstand any current or future shocks and positioned for any potential acquisition opportunities. To that end, we note that cash and cash equivalents represent 1.6x the company's current liabilities as at the six months ended December 2021, allowing for a healthy balance sheet while still reporting high returns on equity (28.7%). The new branch is expected to cost north of $100 million and plans to employ more than 80 people. It is expected that this branch should help to strengthen growth and efficiency, mirroring the effect of the Waterloo branch's addition in 2019 by providing a one-stop-shop experience, in regards to product depth, and driving innovation to make shopping easier for its customers.

In the near term, however, the cost of sales and finance charges are likely to reduce profitability. This is due to the cost of sales increasing, and growing at a faster pace than revenue because of supply chain/inflation issues, and foreign exchange variability on revaluations of leases which at times result in FX losses. Inflation continues to be elevated, causing a rise in the cost of inventory and as such, in the near term, gross profit margin is likely to be negatively affected, which translates to less robust net profit growth. Consistent with this, while operating income inclusive of other income grew quarter over quarter by 17.3%, net profit grew only marginally 0.1%; the result of a spike in finance charges due to foreign exchange losses on revaluation. The near term could see reduced growth given inflationary pressures, simultaneously with FX costs, given a portion of liabilities are exposed to currency fluctuation risk. However, we see value for the company beyond its near-term growth prospects, which is supported by its fortress balance sheet. As we consider both the expected improvements for the Company and the clear risks and drawbacks presented by the current economic circumstances, we've issued a **MARKETWEIGHT** recommendation on the Company's stock.

Definitions:

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Inflation / Supply Chain Issues

At present, COVID-related risks have reduced significantly which has supported strong economic activity. Inflation, however, now poses several risks including the fall in customers' disposable income which can affect demand for products, particularly non-pharmaceutical goods. As the cost of goods and services rises globally and locally due to inflation caused by supply chain issues and made worse by geopolitical events, prices are likely to remain elevated for some time as the global issues that have driven the current price increases, remain.

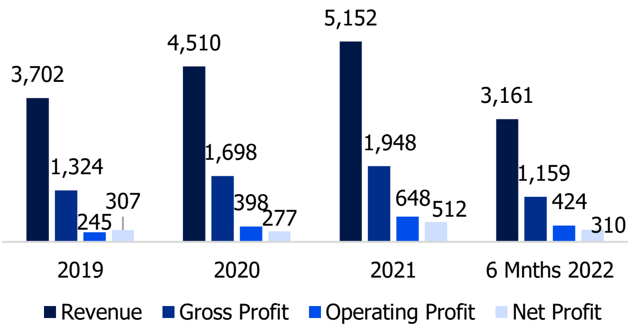
Locally, inflation for the one year ended February 2022 was 10.7%. Simultaneously, the proportion of subcategories within the inflation basket that have seen price increases above 5.0% (midpoint of inflation target) and 6.0% (higher limit of inflation target) has risen to 73.0% and 62.2%, respectively, indicating that inflation has become far more dispersed and embedded. Fortunately, Jamaica's unemployment rate has trended down year over year and should drive consumer demand, but inflation at double-digit rates is likely to impact spending, particularly discretionary spending. The pharmaceutical side of the business, due to its price inelasticity, will continue to serve medical needs despite price risk considering the need for these specific goods. The company still operating in a covid-19 economy absorbed some business costs over the period, to minimize the effect on its customers and may continue to do so in the near to medium term. With inflation being at high levels and ongoing supply change issues this could have an impact on profitability.

Financial Performance (Quarter ended December 31, 2021)

Income Statement

Revenue: For the six months ended December 31, 2021, revenue grew at 19% to $3,161,119,753 compared to the prior period's sales of $2,655,940,587. Despite the ongoing pandemic, the company has continued to strategically grow revenue throughout the period. Revenue for the 2nd quarter totalled $1,854,561,132 compared to prior period $1,542,238,404, an increase of 20.3%. Management has focused heavily on careful management of logistics and shipping so that the quarter, being a holiday season, would not be impacted and enabled them to be fully stocked for the period. In line with this "fully stocked" strategy, the Company has reported a significant increase in its inventory (see balance section). We note that this has been a common strategy across several corporates within the goods distribution and manufacturing industries, in an attempt to mitigate some of the price pressures.

Income Statement Snapshot ($)



Gross Profit: For the period (six months) cost of sales grew by 23% from the prior period, amounting to $2,002,538,523, resulting in gross profit increasing by 14% despite top-line growth of 19%. This lower increase in gross profit indicates that the Company has witnessed margin compression, i.e., its cost of generating revenue is growing at a faster pace than the revenue being generated. This is due to the company facing ongoing supply issues, and accompanying price increases, due to the covid-19 pandemic and the going geopolitical issues from Eastern Europe. As such, global container freight charges have risen north of 500%.

Operating Profit: Earnings before finance charges and taxes grew by 14.3%, standing at $423,858,034 and resulting in a 13.4% margin compared to last period's operating profit of $370,58,473, and an operating margin of 14.0%. Expenses grew at 13.8% over the prior period and reflected 23.3% of sales compared to the prior period of 24.3%

Net Profit: Net profit amounted to $309,962,840 for the six months compared to the previous period of $293,788,424, **an increase of 5.4%**. Profit for the second quarter amounted to $248,836,200 compared to prior of $248,573,661, **an increase of 0.1%.** This significant growth reduction is largely due to foreign currency losses on the revaluation of lease liability, costing the company an additional $36.8 million in finance costs. International Financial and Reporting Standards (IFRS) 16 requires right-of-use assets and lease liabilities, to be initially measured at the present value of the minimum lease payments. Lease contracts denominated in a currency different from the operating currency of the company could result in expense volatility which ultimately affects profitability. As the functional currency (JMD) depreciates against the lease liability currency (USD), future payments rise, causing a revaluation of the initial lease resulting in foreign exchange losses to account for this change. On the inverse, as the functional currency appreciates, the opposite will occur. Over the medium to long term, the local currency (JMD) is likely to depreciate due to structural factors such as the inflation differential between Jamaica and her major trading partners (particularly the US), interest rate differentials, and Jamaica's persistent negative net investment position.

Balance Sheet and Cash Flow

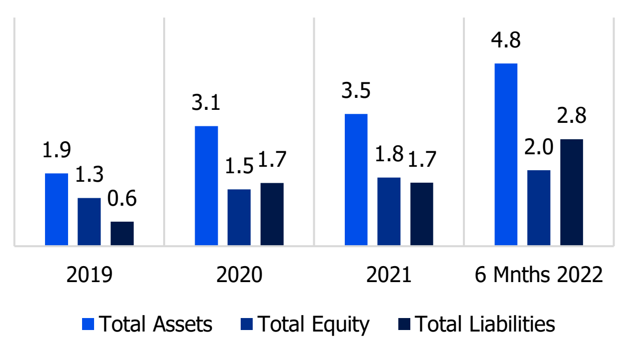
Assets: Total assets stood at $4.797 billion compared to the prior period of $3.411 billion, an increase of 40.6% and an increase of 38.2% over the year ended 2021. One of the drivers of this increase is the debt taken on for expansion in Q2 of the 2022 financial year. The balance sheet is funded 59% total liabilities and 41% total equity, reflecting a debt-to-equity ratio of 0.94x. Current assets make up 60% of the total asset base with the remaining 40% being non-current assets. Inventories stand at 35% of current assets, while cash stands at 60% of current assets, and 21% and 36% of total assets respectively. Property, Plant, and Equipment make up 16% of total assets, and receivables – 3% of total assets.

Equity: Total shareholders' equity is comprised of issued share capital ($252,589,301) and accumulated surplus ($1,737,670,913). Shareholders' equity increased by 18.0% over the prior period and 10.2% over the financial year ended 2021.

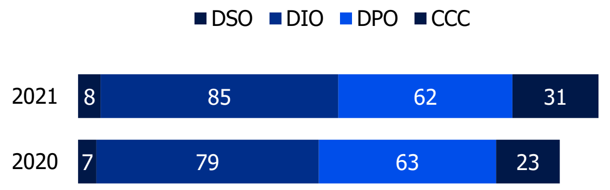
Liabilities: Total Liabilities stood at $2.807 Billion, an increase of 68.6% compared to the 2021 year ended amount of $1.665 Billion. This is due to additional debt funding being brought on to support growth along with a 59% increase in payables, and foreign exchange effects on lease liabilities. Trade payables make up 86% of current liabilities, and 33% of total liabilities. The Company saw an increase in long-term debt due to unsecured notes raised and an increase in lease liabilities due to the effects of foreign exchange on revaluations.

Liquidity and Solvency: The Company over the years has shown great liquidity and solvency and has maintained relatively low leverage despite an increase in long-term liabilities. Current ratios have steadily improved over the years from 2019 to 6 months 2022 from 1.65x to 2.71x. Quick ratios and cash ratios have also steadily improved over the same period. Cash ratios have vastly moved upwards due to the company's growth in its cash levels and are supported by its relatively low cash conversion cycle. Trade receivables for the 6 months ended December 2021 compared to year-ended June 2021 increased by 9%, while trade payables over the same period increased by 59%, allowing the company to retain cash flows longer. The company's ability to owe vendors for longer periods allows for a shorter cash cycle and cash owed to be retained longer. The company has a low Days Sales Outstanding (DSO) which allows quick conversion of receivables into cash. In the cash conversion, the Company has a relatively low cycle with Days in Inventory (DIO), being the longest portion. This represents how quickly a business turns over inventory. A lower day's inventory outstanding means the company is converting its inventory to sales more rapidly and receiving cash faster. The inventory increase by the company has been a strategic one and has caused the cash conversion cycle to increase. However, the increased CCC is still relatively low, highlighting efficient cash conversion management. In the

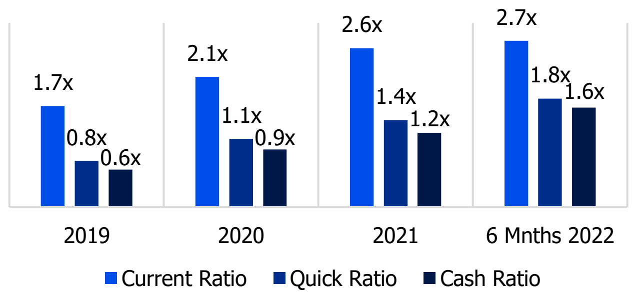
Balance Sheet (In Billions)



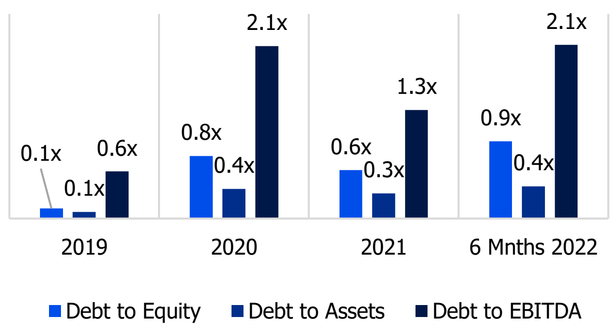
CASH CONVERSION CYCLE (IN DAYS)



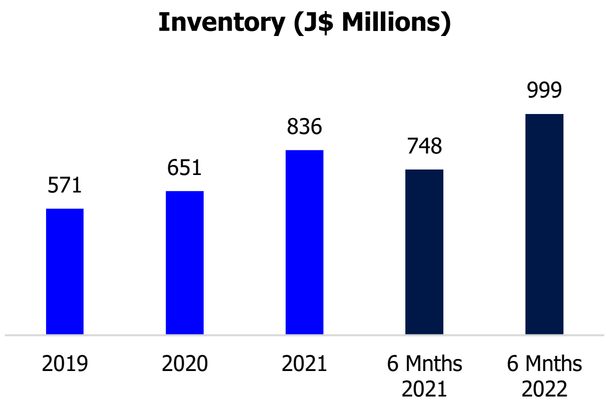
Liquidity Ratios



Debt Ratios

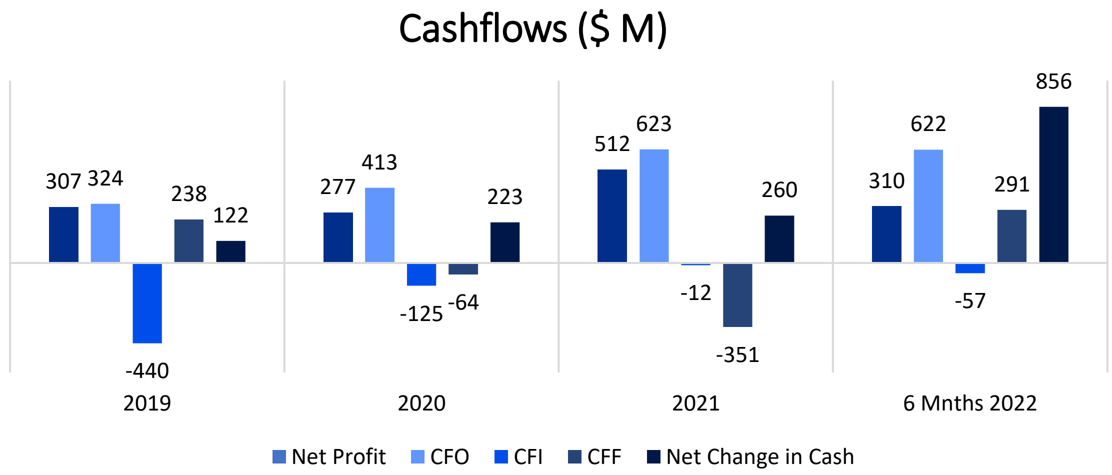


2021 financial year, even though still at low levels, there was an increase in the receivables portion of the cycle from delays in receiving payments, causing a slight increase in the cycle.
Debt levels are also at reasonable amounts, with the uptick in debt to operating income in the 6 months ended 2022, is due to the Company raising an unsecured note amounting to $ 492,425,200. This is to support construction costs and other expansion and growth plans. It is to be noted that the company has enough liquidity to cover its current liabilities with cash and cash equivalents standing at 1.62x.



Cash Flow:
Cash flow from operations has shown to be strong over the years with net operating cash flow increasing consistently. Cash flow from operations for the 6 month period ended December 2021 shows 2.01x its net income due to payables improving cash retention. Net Change in Cash has shown growth over the period ended 2019 to 6 months ended 2022 of 601.6%, with cash flow from operations consistently surpassing net income, indicating that the company has very good working capital management.

The Company's net operating cash flow can support greater capital expenditures (CAPEX) and flexibility on payments. The Company's basic free cash flow, or its economic cash flow (operating cash flow less CAPEX needs) has remained at high levels relative to net income in recent years, being on average 27% higher. This consistent cash flow from operations above net income places the Company in a position to make CAPEX-intensive decisions without a significant need to rely on external financing. Cash outflows from investing activity have remained relatively low as a consequence of the Company's low maintenance CAPEX needs, with the year ended 2019 reflecting the only year the Company has paid for large-scale expansionary CAPEX. Going forward, the company is expected to utilize expansionary CAPEX to support its new location opening, which would present a higher cash outflow from investing activities during the expansion period. Thereafter, the company's CAPEX needs are likely to return to maintenance CAPEX levels.



Valuations & Recommendation

DCF Valuation -

Our five-year free cash flow to equity model assumes that over the next year, sales will grow at 15%, a slight increase over the previous full-year growth of 14.2%. We use a three-step growth model to reflect the expected pickup in sales growth to 21% in the second year given the expansion efforts. This then gradually slows down to what we consider our long-term terminal growth rate of 7.4%.

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Operating Margin is expected to gradually rise over time than fall to the levels of previous historical averages in its terminal year. Net profit margin over the forecasted period is expected to be on average 9.5%.

We adjust cash flow from operations to get to free cash flow, net of capital expenditure needs, and adjust for expansionary capital expenditures. We then adjust for net changes in debt (repayments and any new cash proceeds) to get to our free cash flows. The cost of equity was determined at 13.26% to get our equity value of $12,350,965,428.54 resulting in a share price of **$9.89**.

P/E Valuation -

Our price to equity valuation utilized our DCF forward year outlook in sales of $6.507 Billion and a net profit margin of 9.4% to arrive at a profit of $611.7 million; and earnings per share of $0.49. The stock is currently trading at 23.76x, a little above the normalized Junior Market average of 22.11x. When we utilize this market average and our forward EPS, we arrive at a valuation of $10.82.

Averaging our P/E and DCF estimates we get a future price of $10.36, a 3.03% upside relative to the March 25, 2022, close price of $10.05, suggesting the stock is trading within its fair value. In consideration of our estimated fair value and the aforementioned discussion regarding the Company's outlook, we've issued a **MARKETWEIGHT** recommendation.

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