Barita

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Summary Analysis

FONTANA LIMITED

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Fontana Limited Summary Analysis

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.

Valuations & Recommendation

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	

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%.

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.

Definitions:

Sell = REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO
UNDERWEIGHT = REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET
MARKETWEIGHT/HOLD = EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO
OVERWEIGHT/BUY = EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO