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LOCAL EQUITY REPORT

LUMBER DEPOT LIMITED

Barita investments Limited
15 St. Lucia Way, Kingston
Tel #: 1-888-429-5333

Company Overview

Stock	LUMBER
Close Price	J$3.97
Justified PB Valuation	J$3.96
PE multiple Valuation	J$5.14
Estimated Fair Value	J$4.55
Potential Upside	**14.64%**
Dividend Yield	1.01%
Total Return	**15.65%**
Year to Date Return	31.46%
Trailing P/E	15.06x
Forward P/E	12.98x
Recommendation	**OVERWEIGHT**
March 7, 2022	

Lumber Depot ("the company") is a full-service hardware store in Papine that serves large and small-scale building contractors as well as homeowners doing construction projects, renovations, and repairs. The company was formed from the split of Blue Power's Hardware business with the transfer of assets taking place on November 1, 2019. The company's business model involves the sale of construction materials, hardware, plumbing, and electrical fixtures at 17c Gordon Town Road in Papine, St. Andrew, where the Hardware Business has operated for the last 21 years. The site includes purpose-built warehousing, loading bays, retail space, and office facilities. The Company also operates an off-site overflow storage facility at 4 Victoria Avenue, in Kingston.

Summary and Outlook

Since listing on the JSE, the Company has outperformed its projections and has consistently delivered solid net profit growth (from J$76.98 million in FY2019 to J$144.99 million in FY2021). To a large extent, this has been driven by better than projected efficiency as the Company has maintained low expense ratios and consequently, relatively high margins. While revenue growth has been commendable (9.28% compounded annual growth from FY2019 to FY2021), we note that in the future, higher revenue growth will be essential to maintain the current level of net profit growth, which has thus far been heavily driven by margin expansion. In that regard, we believe that the tailwind from the growing construction industry as well as the company's new commitment to invest more into building greater capacity will bode well for revenue growth.

Additionally, we must note that we are optimistic about larger network-related possibilities that may materialize following the purchase of shares in the Company by Stony Hill Capital. Stony Hill Capital (an entity with close connections to the Musson Group) has elected two directors to the board of lumber, Paul "PB" Scott and Melanie Subratie. We mention the possibility for a larger network as this can support Lumber's reach and scale given the wide business reach of the Musson Group, PB Scott, and by extension, Stoney Hill capital. Collectively, the reach of these entities and connected persons spans several domestic and regional businesses and real estate properties. The two appointed directors also bring substantial business acumen with PB Scott being a board member of several large companies including Facey Group, T Geddes Grant, GENAC, etc via their affiliation to Musson.

While we note these positives, headwinds such as the increase in domestic interest rates spurred by the persistence of domestic and global inflation might provide short-term challenges to the domestic economy and construction demand as a whole in the short term (our forecast horizon was for approximately 1 year). There also exist challenges in the operating environment where volatile lumber prices can have significant impacts on the company's margins. **We do however believe that there is a high possibility of the company outperforming in the short term, particularly as the next quarter Q3 January 2022 should be favourable given the reopening of the economy and less loss of work time.** In the longer term, however, we remain cautiously optimistic given the headwinds described prior. Given these factors, we still believe an **OVERWEIGHT** rating for Lumber Depot is appropriate at this time.

Industry Overview

As we consider the growth potential of Lumber Depot, we briefly analyzed the state of the Jamaican economy and the construction industry, specifically, as this industry would greatly drive the business growth of the company since Lumber products are integral to the industry. It is noted that the Jamaican economy is still delivering output below its pre-pandemic level. The latest GDP figures from STATIN indicate that the Jamaican economy grew by approximately 5.8%

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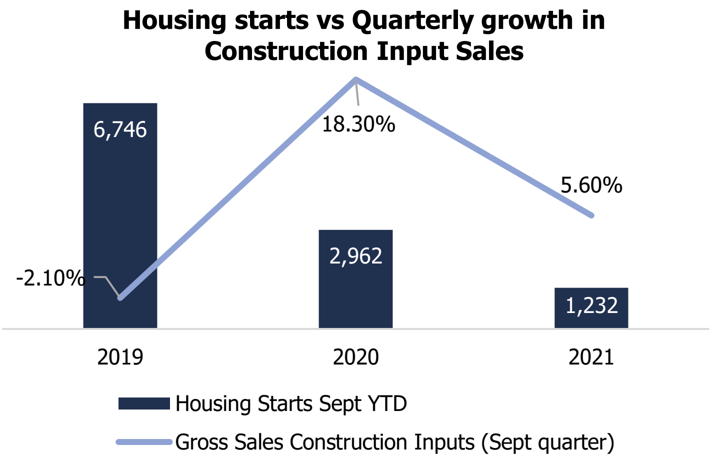
(quarter over quarter) during Q3 2021. While this growth was primarily fueled by outlier growth linked to recovery in the tourism and entertainment-linked industries (Hotel & Restaurants: 114.6%, Transport Storage & Communication: 8.8%), the construction industry also had a commendable growth outturn of 4.4% which followed by 2 quarters of double-digit growth. Within that vein, construction has recorded one of the most consistent growth rates throughout the pandemic, reporting average growth over the last 5 pandemic-plagued quarters of 9.12%. Construction was one of only two industries that consistently grew over the last 5 quarters with the other being government services.



We would however note that the data suggests that activity in the construction industry has slowed somewhat. This is inclusive of a slowdown in growth as the recent 4.4% outturn for Q3 2021 is lower than the 10.5% and 17.4% reported for Q1 and Q2, respectively. Other indicators have also implied a slowdown in the industry. This is inclusive of a reduction in total housing starts which amounted to 2962 in the Jan-Sept 2020 period compared to 1232 for the same period in 2021 (representing a 58.4% decrease). For the latest July to September quarter 2021, the gross sale of construction materials rose in real terms by 5.6% compared to the same quarter last year, this being driven by a 14.8% increase in the wholesale sale of inputs and a 5.4% increase in the retail sale of Hardware, Construction Materials, Paint and Glass. This compares to the growth of 18.3% that we saw in the same quarter for 2020 consisting of 52.1% of growth in wholesale sales and 18.7% for Retail Sale of Hardware, Construction Materials, Paint, and Glass.

The other potential downside includes the monetary environment where we note that there have been several increases in domestic interest rates by the central bank. While we don't expect this to extend far into the medium to long term, BOJ data indicates that the extension of credit to the construction and land development sector (outstanding loans and advances) has declined by approximately 8.2% with all subcategories suffering declines with Construction falling 7.9%, Land Development 11.6% and land acquisition 9.7%. Notwithstanding, while the central bank has posited to be more hawkish in recent times, real interest rates remain negative and therefore, still conducive to output growth (although the possibility of even further increases is still on the cards).

Now, the current growth slowdown is expected given the higher-than-average growth at the initial stages of the pandemic recovery. Therefore, as the industry is back to pre-pandemic levels, less robust growth is normal. What has been quite clear, however, is that construction has been far more resilient than most other recorded industries. Comparatively, despite returning to its pre-COVID level of output, construction continues to grow well above the economy's "steady state" growth, which was below 1%, before the pandemic.

We also believe that this current and historical above-average and above-trend growth is likely to persist, **owing to structural reasons such as continued demand for housing driven by demographic factors which should continue. This is evidenced by the current administration's medium-term housing plan to add 70,000 new units by March 2025 and hence the National Housing Trust's (NHT's) aim to increase housing expenditure from $51,991.78 million in FY 2020/21 to $71,833.58 million in FY 2024/25. This is coupled with the government's continued efforts to improve domestic infrastructure. For example, the September quarter capital expenditure for 2 of the 4 sub-agencies surveyed by the Planning Institute of Jamaica (PIOJ) had increased infrastructure spending. There also exists tailwinds from the strong rebound in tourism where it was noted that there currently exists over 8,000 new units in development at different stages in the tourism industry.**

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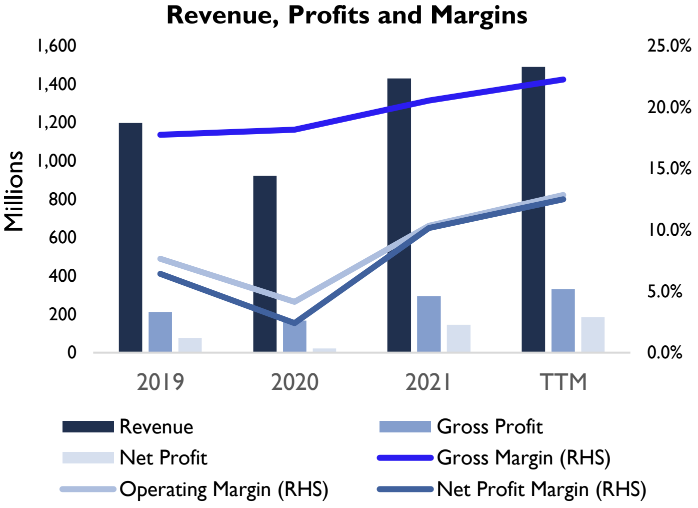
Altogether, we believe that its exposure to the construction industry places Lumber Depot in an advantageous position for growth in the long term. We, however, note short-term headwinds which include the bank of Jamaica raising the policy interest rate to 4.0% and persistent inflation, particularly in construction equipment which might weigh down on the short-term performance of the industry as these pressures persist.

Financial Analysis

Strong Revenue Growth and Efficiency

Since its Junior Market listing in December of 2019, the company has shown strong financial performance. This is evidenced by Compounded Annual Growth Rate (CAGR) of revenue which was 9.3% over the 2019-2021 financial years. Moreover, the company's gross profit and Net profit have grown by a CAGR of 17.5% and 37.2%, respectively, over the same period. Before its junior market listing, Lumber operated under the Blue Power Group as its Hardware division which was subsequently split (with the relevant assets being transferred). If we also considered the period over which the company was still just a segment of Blue Power, Lumber grew revenue during the 2015-2021 period at a CAGR of 11.72%. (We also estimate that the company would have increased revenue in the 2020 year after approximations. Approximations were necessary since only 9 months to April 2020 data was officially given).

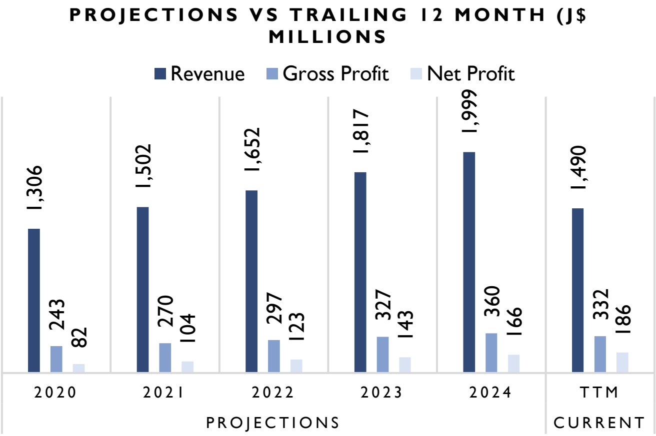


The overall improvement in net profit over the 2019-2021 financial years has mainly been due to improved efficiency. This is represented by the improving gross profit and operating profit margins. Management has chalked up the improvement in gross profit margins to aggressive marketing and sales while operating efficiency has been increased post listing due to the split from Blue power group and management's subsequent effort to reduce previous group expenses. Management has also highlighted that to combat rising commodity prices they increased inventory holding, improved relationships with key suppliers, and have also sought to strategically purchase both domestically and overseas as necessary to minimize costs.

The company's latest 6 months performance also follows the trend of continued revenue and net profit growth, except for a relatively stagnant Q2 2022 outturn where revenue grew by only 0.45%. Note that the relatively weak Q2 2022 performance, which in turn have impacted the 6-month 2022 outturn came on the back of the company missing 17 working days for the quarter which roughly equates to 23.6% of the working days of the quarter (the company has still grown revenue for every quarter since listing on a quarter over quarter basis). Despite this, net profit for the 6 months grew 62.3%. This was driven by strong revenue growth primarily during the relatively lockdown-free first quarter, with this growth being matched with overall efficient containment of operating expenses.

Performance Meeting Management Forecasts

The company provided forecasts for its financial performance for the period 2021-2024. From this, we can see that the company is projected to make $1.5 billion in revenue during FY2021 and a net profit of $104.0 million. For the latest FY2021 audited financial release, the company has only marginally missed the revenue target by 4.8% while it has greatly surpassed its net profit target by 39.5%. The audited FY2021 net profit outturn of $144.99 million is beyond what the company projected to make in FY2023 (as per the chart); hence beating the FY2023 target 2 years early.



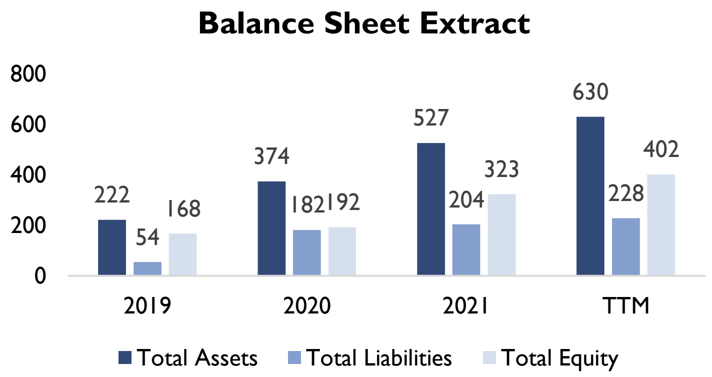
In FY2021, this outperformance relative to the target was due to several factors. Firstly, the company enjoyed greater gross profit margins than forecasted which offset the slightly below projected outturn for revenue and revenue growth. The forecasted gross profit margin was 18.0% compared to the actual of 20.5%. Interestingly, this came at a point where global inflation has been high, particularly in that of Lumber prices due to pandemic demand coupled with supply chain disruptions, indicating that Lumber has significant capabilities in managing its costs.

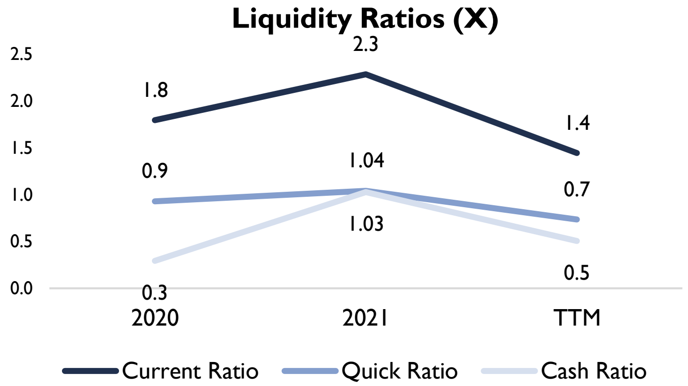
Likewise, the company was able to keep operating expenses below projections. The operating expense ratio was 10.8% compared to the forecasted 10.9%. The combination of higher gross margins and management's ability to contain expenses led to 39.5% above target performance in net profit as stated earlier. **Given that this performance was obtained primarily by cost efficiency, particularly in an environment riddled with supply chain issues, we believe that this outperformance relative to forecast is sustainable in the medium term.** That is we expect management to be able to continue its effective margin management albeit we note the possibility of slight deterioration due to the current volatility in lumber prices (large two-way movements) where large declines might hurt the company margins (higher cost of goods sold and lower revenues)**.**

Balance Sheet

As of October 2021, Lumber had total assets of $629.9 million which represents year-over-year growth of 45.1%. Notably, in its latest financials, the Company has changed the composition of its asset base, utilizing a larger share of non-current assets. This reflects the company's strategic investment plans, as it purchased its current base of operations, which it leased prior, as well as making land acquisition as it seeks to improve production capacity.

These changes have thus led to a reduction of the company's liquidity ratios, namely the current ratio and quick ratio were 1.4x and 0.7x, respectively, down from 2.2x and 1.0x, as at October 2020. This was due to the purchase of property and land leading to the rise of current liabilities, as a portion of the money associated with the purchase and current owed represents short term





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monies owed to Co-Trade Limited (a subsidiary of former parent, Blue Power Group) from which the purchase of the current location at 17c Gordon Road Papine is being made. This then necessitated a $127.60 million increase in current liabilities.

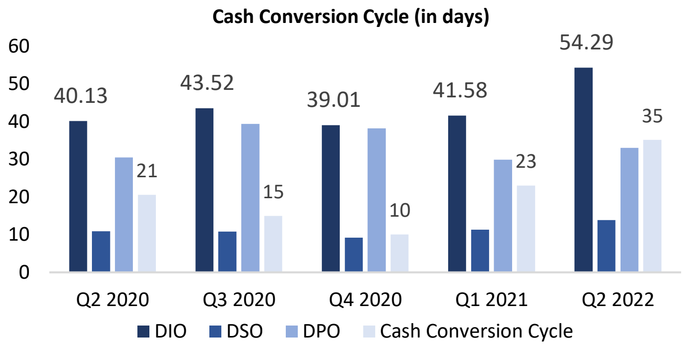
Despite this, we note that the company still has an adequate liquidity position with a current ratio of 1.4x. Of note, this is further supported by the fact that the short-term payable represents money owed to a related party and the company has sufficient capacity to take on additional debt to cover short term cash flow, as well as sufficient liquidity in investments (primarily being in US corporates and mutual funds) to the tune of $118.6 million if needed which is currently classified as non-current.
In summary, Lumber Depot owes Cotrade $127.6 million but has approximately $233.6 million in cash and investments that can sufficiently cover this amount owed.

As it relates to solvency, the company has reduced its total liability/Equity from 94.6% as of April 2020 to 56.7% as of the latest October 2021 financial statement. This was primarily driven by the continued profitability of the company which in turn boosted retained earnings from $22 million in April 2020 to $232.0 million in October 2021 (Y-O-Y for the latest quarter total equity grew by 55.7%). This coupled with the much slower rise in debt has led to a great improvement in the company's solvency position (Y-O-Y for the latest quarter total liabilities grew by a lower rate of 29.6%)

Cashflows

From the latest 6-month financials the company generated $169.21 million in operating cash flows. This is a significant improvement from the $63.10 million generated in the same period of 2020. This cash was however utilized heavily during the period as the company reinvested via its prior mentioned investment into new land space which came for $164.41 million.

As it relates to financing activity, the company had a $28.24 million outflow related to dividends payments. Historically, Lumber has generated significant operating cash flows which led to an increase in the cash balance from just under J$29.08 million in April 2020 to over J$115.06 million as of the latest October 2021 financial report. The company during this period has not been increasing debt and has been using this operating cash flow to finance debt repayment and dividends and as seen recently, increasingly using it to reinvest.



To provide further depth as it relates to the company's cash flow and liquidity, we looked at the company's cash conversion cycle (in this case we looked at it quarterly). From this, we see that for the latest quarter relative to the same quarter in 2020, the company's cash conversion cycle has increased. This means the company is now taking a relatively long time to convert inventory and receivables to actual cash. The main reason for this is the increase in Day's Inventory Outstanding (DIO) from 40 days during Q2 2020 to 54 days during Q2 2021. This is due to the company holding a larger amount of inventory (from J$31.73 million to J$161.66 million). **Of note, this is not immediately concerning to us as we have noted the volatility in prices on the global market, particularly lumber, as well as the current supply chain issues would necessitate additional storage of inventory. The Company's increased inventory suggests management understanding of the current environment and places Lumber in a better position; providing some insulation from volatile prices and potential supply dislocations.**

Valuation and Outlook

To value the company, a P/E valuation approach was used. We firstly forecasted the company's forward earnings and arrived at an EPS of approximately J$0.31 for the financial year ending April 2023. Key assumptions used in this forecast include a continuation of the pace of revenue growth that the company has seen in recent quarters that have not been significantly affected by COVID-

19 lockdowns, particularly as the economy reopens and restriction measures ease leading to less loss of work time as was the case for the company's latest Q2 2022. These positives were, however, somewhat tempered due to the potential demand dampening effect of the recent interest rate increases spurred by continued inflationary pressures. We've also considered continued volatility in lumber prices which we factored into our forecast. Our expected 2023 EPS of J$0.31 compares to the current trailing 12-month earnings per share of J$0.26.

For the comparable companies, we've used Junior Market companies whose main business line revolved around distribution. Utilizing these companies, we arrived at an average PE multiple of 16.80x. Applying this multiple to the forecasted EPS we arrive at a fair value estimate of J$5.14.

To supplement this valuation, a Justified Book Value metric was also utilized. To this end, we forecasted the Company's sustainable long-run growth rate and arrived at a rate of 6.30%. To put that into perspective, in nominal terms the Jamaican economy has grown at an average rate of 7.37% over the 2007-2019 period while the construction industry, in particular, grew by an average of 7.57% over this same period. Given these comparisons, we believe 6.30% is a reasonable estimate. We then utilized a cost of equity of approximately 12%, developed from a build-up method; determined by adjusting the implied cost of funding from the adjusted for tenor and the recent rise in interest rates.

A forecasted ROE of 31.3% (this compares to the ROE of 56.7% as of the latest 2021 financial statement) was also utilized. From these inputs, we arrived at a justified PB ratio of 4.53x. When we utilize this ratio with a forecasted BVPS of J$0.88, we arrive at a fair value of J$3.96 as our base case scenario. Below we also present a sensitivity analysis of the Justified PB valuation based on different assumptions for the cost of equity and growth. The highlighted area represents likely valuations based on what we believe are realistic ranges for long-run growth and cost of equity:

		Cost of Equity			
		11.0%	11.83%	12%	13.0%
Long Run Growth	3.0%	3.10	2.81	2.76	2.48
	4.0%	3.42	3.06	2.99	2.66
	5.0%	3.84	3.38	3.29	2.88
	6.3%	4.66	3.96	3.84	3.27
	7.0%	5.32	4.41	4.26	3.55

We then utilized a simple average of both our base case metrics for the PE multiple and the Justified PB of J$5.14 and J$3.96 to arrive at our final fair value measure of approximately J$4.55. Based on the close price as of March 3 of J$3.79, this represents a potential upside of approximately 14.6%. Hence, we recommend an OVERWEIGHT rating on the stock. This rating is supplemented by our generally positive view of the sector and the efficiency of the company along with its expansion plans. We however note that there are medium-term risks to our forecast including the possible impact of further rate increases and its impact on demand in the construction sector.

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