

November 2020

Previous Review: May 2020

SEPROD GROUP LIMITED (SEP)

Analyst Highlights

We have updated our previous recommendation!

- Over the nine-month period ending September 30, 2020, revenues amounted to J\$28.66 billion, 16% above the similar period in 2019, while net profits from continuing operations amounted to J\$2.53 billion up by approximately 117% when compared to the similar period in 2019.
- Seprod's strong performance was due to its decisions in 2019 to exit the loss-making sugar business, consolidate its dairy operations, increase exports and expand its distribution capabilities and the overall resilience of its products even amid COVID-19.
- The key drivers of future growth and profitability include consolidating its warehousing operations, expanding contract manufacturing, acquisitions and exports.
- While risks remain that may negatively impact the global supply chain, increase raw material costs and lower consumer's income, we project that Seprod will remain resilient due to the strength of its fundamentals.

Group Overview:

Seprod Group Limited (SEP), founded in 1944, has grown to become one of Jamaica's leaders in manufacturing, distributions and agribusiness. The group now operates three main businesses including: ingredients production such as edible oils, dairy production with brands like (Serge and Miracle) and distribution. In 2018, Seprod acquired Facey Commodity Company (Facey) which is expected to play an integral role in the growth of the company's revenue stream.



Key Features:

Current Price	\$ 61.00
Target Price	\$ 68.14
Implied Upside	11.70%
52 Week High	\$ 70.00
52 Week Low	\$ 30.00
YTD Gain/Loss	19.66%
Current P/E (x)	14.54
Market Capitalization (J\$B)	45.36
Shares Outstanding (Millions)	733.55

BUY

Target Price: J\$68.14

Implied Upside 11.70%

LOW to MODERATE RISK



Seprod Group Limited (SEP)

Seprod's Products and Market Position

- ✚ Seprod is one of two manufacturers of flour in Jamaica. The company also owns 50% of Jamaica Grains and Cereals Limited where they produce cornmeal and flour from its recently completed multi-grain mill under the Gold Seal brand.
- ✚ Seprod is the main manufacturer of cooking oil, margarine and shortening in Jamaica. Through its subsidiary, Caribbean Products Limited, it produces these products under its brands such as Chiffon, Lider and Gold Seal and for several third parties.
- ✚ Seprod is the largest producer of milk in Jamaica. Through its subsidiaries, Serge Island Farms Ltd. and Serge Island Diaries Ltd. they operate Jamaica's largest dairy and produces a range of milk products and juices at its facilities under the Serge, Miracle, Monster Milk and Swizzle brands. Seprod produces sweetened condensed milk in Jamaica mostly under the Betty brand and is also the manufacturer of Supligen for the local and export markets.
- ✚ Seprod also owns Industrial Biscuits Limited, which produces a range of sweet and savoury cookies, crackers and other baked goods under its own Butterkist brand as well as for third-party brands such as Ovaltine and Ms. Birdie.
- ✚ Through its acquisition of Facey, Seprod now controls the distribution of majority of its own brands. Additionally, they now distribute leading global consumer brands such as: Brunswick, Boehringer Ingelheim, Goya, KraftHeinz, Mondelez, Nabisco, Pfizer and Roche.

The products Seprod manufactures and distributes largely fall into the category of Consumer Staples. Typically, the companies in the Consumer Staples sector are less sensitive to economic cycles. These include manufacturers and distributors of food, beverages and tobacco and producers of non-durable household goods and personal products. It also includes food & drug retailing companies.

However, within the Consumer Staples sector, some goods may be classified as necessity goods (those goods whose demand change less than the change in consumer income) while others may be classified as normal goods. Normal goods are those that typically show a direct relationship with the consumer's income. Necessity goods make up the vast majority of Seprod's products and include oil, flour and cornmeal products the group produces. Sales from these products usually form a consistent part of the groups's revenue base and ensures that the group's revenues remain resilient.

Seprod Group Limited (SEP)

Seprod's Performance Amid COVID-19

The COVID-19 pandemic has had a negative impact on Seprod's operations, despite this, the Seprod Group has been able to remain very resilient thus far. Over the last few years, the group made significant investments to diversify the Group's operations and improve its risk management capabilities. One such investment, is its joint venture agreement with Seaboard Corporation, which created a state-of the art milling operation, producing flour and other products. Additionally, investments were made to add a new Tetra Pak line at Serge Island Dairy and a new oven at International Biscuits Ltd. In 2019, Seprod seized the opportunity to merge its two dairy processing operations to form Serge Dairies and is a move it expects will result in significant operational efficiencies, volumes and profitability. Together these and other initiatives have facilitated Seprod's building of a strong export business to augment its local distribution capabilities, which has been boosted by the acquisition of the Facey Consumer business in 2018. In 2019, Seprod continued its focus on export led growth strategy, which resulted in an increase of 20% year over year.



In our last review of Seprod (May 2020) we estimated that FY 2020 could see a decline of up to **14%** when compared with FY 2019. Our estimate factored in a decline of **J\$1.39 billion** from the decision to exit the Sugar manufacturing business¹. Additionally, our projections also overestimated the short-term negative impact of the downturn in the tourism and wider hospitality sector, due to COVID-19 on Seprod's business. Consequently, we estimated a decline in revenues of **J\$1.64 billion** from this sector. Similarly, as a result of the pandemic and the islandwide curfews and various other restrictions to curtail the spread of the virus, supermarket chains, retailers, wholesalers and other channels were projected to see a decline of **J\$1.57 billion**.

As of the end of September 2020, Seprod is on track, to not only beat our earlier estimate but even surpass the revenues posted in 2019 despite the COVID-19 pandemic. For the nine-month period ended September 30, 2020, Seprod posted revenues of **J\$28.66 billion** or almost **16.0%** above the revenues posted over the similar nine-month period in 2019 and already above our full year projection of **J\$28.06 billion**. For the final three months in FY 2020, we are estimating that Seprod's revenues continue to grow and that its full year revenues could reach **J\$36.95 billion**, which includes growth in revenues from exports to **J\$1.62 billion**. In FY 2019, Seprod continued its focus on exports which rose by **20.0%**. In FY 2020 we have estimated a growth in export for Seprod of approximately **15%** or approximately **J\$300 million**.

A company's Gross Margin ratio is an efficiency measure and is important for companies including those involved in manufacturing. Between the periods 2015 to 2019 Seprod's gross margin moved significantly from approximately **20%** to reach **27%**. The expansion in its gross margin reflects that the strategies enacted over the period have had a positive impact on the business and is an indication of the improvement in the fundamentals of the group. For the nine-month period, just concluded, Seprod's gross margin was reported at **37%** and marginally better than gross margin posted for the similar nine-month period last year.

¹ Seprod closed its sugar factory during FY 2019.

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Since 2015, Seprod's operating expense ratio has exhibited an increasing trend moving from approximately **18%** in 2015 to **22%** in 2019. The rapid growth in the Seprod's operating expenses was largely due to the consolidation of the Facey Consumer business in 2018. That year, the group's operating expenses grew by over **62%**, moving from **J\$3.25** billion to **J\$5.27** billion. Seprod's operating expenses for the nine-month period ended September 30, 2020 was **J\$7.78** billion versus **J\$6.99** billion over the similar period in 2019.

The nine-month net profit for the period ended September 30, 2020 was **J\$2.48** billion, an increase of **557%** above the similar period in 2019. The increase in the nine-month period's profits this year was partly due to a one-off gain of **J\$762** million from the sale of its property, as well as the efforts made to strengthen the fundamentals of the business over the years. When its nine-month profits are adjusted for the one-off gain from the sale of the property, Seprod's amounts to **J\$1.72** billion, which is still significantly above the profits posted over the similar period in 2019.

In our previous review we projected that Seprod's profit would be approximately **J\$1.76** billion for in 2020 due to the reasons highlighted above. However, given the strength of Seprod's results so far, the group is projected to surpass our 2020 projection, if the trend



continues, the decision to combine the dairy plants is expected to continue to drive efficiencies for the Group and improve the flexibility to respond to its consumer's demand by giving Seprod more control of the supply chain from its factor to consumers.

Looking Ahead

Over the medium-term, the group is focused on more opportunities to deliver efficiencies throughout the business. To that end, Seprod will be investing more to improve its distribution, warehousing and logistics efforts to improve the efficiency at which they deliver their products across the various channels. Particularly, its project to consolidate its warehousing operations is expected to improve the group's cost competitiveness and have a high customer focus. The project which began in 2019 is expected to continue into 2021 and will be supported by an expanded distribution fleet.

We expect that the consolidation of its warehousing, if successful, may continue to lead to reductions in operating costs, as duplicated expenses are expected to be at least reduced if not eliminated. For example, we anticipate reductions in security costs, insurance expense, warehouse rental and inter warehouse shipping expenses among others. Importantly, the increased warehouse space also means that the unit cost of production is likely to be reduced due to longer production runs. There is also the higher possibility for new products to be carried while stock outs would become less likely, given the availability of storage space. Consequently, we project that the group's gross margin continues to improve over the next five years, climbing from **27.0%** in 2019 to average **33.0%** while its operating expense ratio is projected to decline south of **20.0%**.

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While uncertainty remains at high levels, with many downside possibilities, the likely knock-on effect of the growing revenues and increase operational efficiency, is that Seprod continues to grow profitability. The groups’ strong balance sheet and history of revenue growth through all economic cycles make it well-positioned to not only be more resilient but deliver strong results over the medium to long-term.

Positives	Negatives/Risks
<p>Diversified Operations: The group operates in three main segments (distribution, ingredients and agribusiness) which allows Seprod to have a more reliable revenue stream. The diversity in its operations reduces the pressure on Seprod to succeed through one segment.</p>	<p>Mature local Market: Seprod operates in a mature local market. As a result, the rate of growth in the segments it operates in are low. In response to this, the group has increasingly looked towards export for growth.</p>
<p>Strong/Defensive Products: Majority of the products Seprod’s produces/distributes are consumer staples. These include oils, cornmeal, flour, milk and pharmaceutical items. Typically, these goods are bought by consumers regardless of the changes in their income and therefore make these products less sensitive to economic shocks.</p>	<p>Weak Macroeconomic Environment: The Jamaican economy will contract in 2020 as the COVID-19 social distancing measures have placed severe restrictions on much of the productive capacity of the country. As a result of the shuttering of many businesses, many jobs have been lost. The expected spike in unemployment and the expected reduced flows from remittances will result in depressed consumption in the short to medium term</p>
<p>Strong Distribution Network: Seprod, in recent years, has developed a good distribution network with its two companies Industrial Sales and Facey Commodity. The acquisition of Facey Commodity Company has boosted the efficiency of Seprod as a distributor and enabled the group to deliver its products to its customers efficiently.</p>	<p>Supply Chain Disruptions: With economies across the globe still operating with restrictions in place, the normal flow of goods and services have been disrupted and could see further disruptions as social distancing measures are adjusted as COVID-19 evolves. Several of Seprod’s products are raw materials used in its manufacturing process and have a high import content which makes them even more susceptible to supply chain disruptions. Supply chain disruptions may lead to increases in cost and could threaten Seprod’s profitability.</p>
<p>Strong Brand: Seprod currently owns and distribute some of Jamaica’s strongest consumer brands, which builds customer recognition. Having a strong brand makes it easier for the group to introduce new products to grow revenues, among other advantages.</p>	
<p>Geographically Diversified Revenues: While Seprod’s revenues are primarily generated in Jamaica. It currently generates revenues in countries all over the Caribbean, UK, Canada and Africa. Revenues from exports are also one of the group’s key strategies for future growth. Seprod hopes to expand its exports by 25% yearly.</p>	



Seprod Group Limited (SEP)

Valuation Analysis

The estimated fair value of Seprod's stock was computed utilizing a Free Cash Flow to Equity (FCFE) method.

Free cash flow to equity is the cash flow available to shareholders after all operating expenses, interest, and principal payments have been paid and necessary investments in working capital and fixed capital have been made. FCFE is the amount that the company could afford to pay-out as dividends to its shareholders.

The group is projected to earn Free Cash Flow of **J\$3.11 billion** in financial year 2020 before growing to **J\$5.67 billion** in 2025. With a required return on equity of **14.12%** and a sustainable growth rate of **4.18%**, Seprod's target price estimate is **J\$68.14**.

Analyst Opinion

Seprod is one of Jamaica's premier food manufacturing companies with over 75 years' experience operating locally. Over the period, the group has grown to include several diverse food subsidiaries with easily recognizable household brands. The group currently enjoys a very strong presence in the local market, where it leads in several segments, and continues to enjoy reasonable success within the Caribbean and strong growth prospects in the United Kingdom, Africa, United States and Canada.

With the onset of COVID-19, restaurants, supermarkets, bakeries and corner shops in communities have been forced to operate within restricted parameters or have completely shuttered. Although the COVID-19 pandemic has had a negative impact on Seprod's operations, the Group's diversified portfolio has proven to be resilient thus far. Looking ahead, there are still risks that could negatively impact global supply chains and ultimately affect raw material prices, consumer income and economic growth. Notwithstanding, given our estimate that the worst part of the covid-19 restrictions may be behind us, we are expecting that the companies good performance could likely continue into at least the short term.

Over the last five years, the group has invested significantly in strengthening its operations and its resiliency. The investments include consolidating aspects of its business where costs were being duplicated, which is a move to position itself for continued resilience and competitiveness in face of the uncertainty which lies ahead. Over the medium-term, the group has further investments plans to improve its distribution, warehousing and logistics efforts that are expected to augment the Groups' profitability over time.

Our valuation puts Seprod's stock at **J\$68.14** while the stock price is currently **J\$61.00**, implying a **11.70%** upside. Additionally, with a dividend yield of approximately **2.78%**, a total return of **~14.48%** is implied. We therefore recommend that clients **BUY** Seprod's stock and assign a **LOW** to **MODERATE** risk rating to the security.

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APPENDIX

Seprod's Income Statement						
	ACTUALS					
	2014	2015	2016	2017	2018	2019
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
Revenue	14,007,117	13,777,863	15,781,917	16,511,206	22,499,784	32,694,821
Direct expenses	(11,216,211)	(11,114,536)	(12,291,448)	(12,687,358)	(15,585,707)	(23,894,709)
Gross Profit	2,790,906	2,663,327	3,490,469	3,823,848	6,914,077	8,800,112
Finance and other operating income	682,791	760,629	1,051,619	753,103	841,184	1,313,817
Selling expenses	(399,517)	(510,648)	(589,830)	(624,930)	(708,646)	
Administration expenses	(1,416,111)	(1,798,595)	(2,171,049)	(2,352,441)	(4,506,503)	(7,336,293)
Other operating expenses	(197,591)	(213,890)	(192,493)	(268,611)	(57,832)	24,999
Operating Profit	1,460,478	900,823	1,588,716	1,330,969	2,482,280	2,802,635
EBITDA	1,887,511	1,352,233	2,077,261	1,809,191	3,174,705	3,703,461
Finance costs	(289,833)	(290,054)	(374,631)	(337,773)	(737,983)	(1,472,947)
Share of results of joint venture	-	(6,711)	(28,161)	(54,236)	57,930	57,705
Profit before Taxation	1,170,645	604,058	1,185,924	938,960	1,802,227	1,387,393
Taxation	(270,244)	(281,317)	(310,715)	(291,117)	(378,757)	318,255
Net loss from discontinued operations						(732,314)
Net Profit	900,401	322,741	875,209	647,843	1,423,470	973,334

Seprod's Balance Sheet						
	2014	2015	2016	2017	2018	2019
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
Non-current Assets						
Property plant and equipment	3,820,236	3,907,037	4,116,287	4,101,869	7,427,259	7,197,435
Right of use assets	-	-	-	-	-	1,040,734
Intangible assets	7,975	4,234	1,694	-	9,657,764	9,414,737
Investments	2,752,296	1,628,304	1,495,919	1,369,574	1,414,445	1,500,210
Investment in joint venture	-	427,403	399,242	345,006	402,936	454,070
Long term receivables	1,096,044	2,584,476	3,543,922	2,243,724	703,774	713,815
Post-employment benefit asset	-	-	40,300	38,500	36,000	35,100
Biological assets	317,976	250,759	236,343	292,628	342,564	409,370
Deferred tax assets	74,989	73,701	20,063	19,237	702,772	1,299,895
	8,069,516	8,875,914	9,853,770	8,410,538	20,687,514	22,065,366
Current Assets						
Inventories	1,934,453	1,746,461	1,930,268	2,495,063	6,548,105	6,914,312
Biological assets	659,227	510,516	513,198	508,745	439,303	286,549
Receivables	1,957,832	1,740,697	3,991,910	6,175,651	5,043,326	5,239,220
Available-for-sale investments	9,627	-	-	-	-	-
Financial assets at fair value through	594,595	807,069	-	-	-	-
Current portion of long term receivables	65,370	121,836	76,439	1,487,134	372,096	17,500
Non-current assets held for sale	-	-	-	-	-	289,241
Taxation recoverable	27,042	38,178	29,754	93,631	152,685	210,060
Short term deposits	134,457	142,824	153,906	-	-	-
Cash and bank balances	583,787	1,312,707	667,505	837,294	2,055,335	1,476,292
Total Current Assets	5,966,390	6,420,288	7,362,980	11,597,518	14,610,850	14,433,174
Total Assets	14,035,906	15,296,202	17,216,750	20,008,056	35,298,364	36,498,540

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Seprod's Balance Sheet Cont'd

Current Liabilities						
Payables	1,247,604	1,981,790	4,468,479	6,807,507	6,373,833	6,321,220
Current portion of long term liabilities	916,268	1,447,781	2,182,838	2,012,776	2,051,691	829,438
Current portion of lease obligation	-	-	-	-	-	67,731
Bank overdraft	33,693	-	-	-	-	-
Provisions	10,631	-	-	-	-	-
Taxation payable	71,390	86,876	9,198	70,587	139,731	235,285
Total current Liabilities	2,279,586	3,516,447	6,660,515	8,890,870	8,565,255	7,453,674
Net Current Assets	3,686,804	2,903,841	702,465	2,706,648	6,045,595	6,979,500
	11,756,320	11,779,755	10,556,235	11,117,186	26,733,109	29,044,866
Equity attributable to Stockholders of the						
Share Capital	561,287	560,388	560,388	560,388	5,768,558	5,768,558
Treasury Shares	(899)					
Capital reserves	1,417,863	1,202,614	1,070,229	943,884	993,334	1,097,200
Retained earnings	8,099,377	8,546,526	8,137,327	8,384,942	8,983,102	8,104,479
Total shareholders' equity	10,077,628	10,309,528	9,767,944	9,889,214	15,744,994	14,970,237
Non-controlling Interest	(286,315)	(575,368)	(792,202)	(879,402)	(999,372)	-
	9,791,313	9,734,160	8,975,742	9,009,812	14,745,622	14,970,237
Non-current Liabilities						
Post-employment benefit						
Post-employment benefit obligations	1,406,028	2,979,000	143,000	148,400	136,200	148,300
Long term liabilities	200,979	1,565,114	1,245,659	1,716,732	10,327,786	11,393,938
	-	-	-	-	-	1,105,372
Deferred tax liabilities	358,000	1,825,810	191,834	242,242	1,523,501	1,427,019
	1,965,007	2,045,595	1,580,493	2,107,374	11,987,487	14,074,629
	11,756,320	11,779,755	10,556,235	11,117,186	26,733,109	29,044,866

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