

November 2019

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# Security Review: Lumber Depot

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Prepared by:  
JN Fund Managers Ltd.'s Global Investment  
Research Unit

## Company Overview

The Lumber Depot Ltd. (LD) was formerly a division of the Blue Power Group (BPG), the second entity to be listed on the Jamaica Stock Exchange's (JSE) Junior Market in April 2010. The Company which has been operations as a part of the group for over twenty years was formally incorporated July 30, 2019. The

### Key Features:

IPO Price	J\$1.20
Trailing 12M Earnings Per Share	\$0.11
Est. Fair Value	J\$1.52
Discount to Fair Value	26.67%

Company, Lumber Depot Ltd., sells hardware and building materials from its single location on Gordon Town Road in Papine, St. Andrew and posted revenues in excess of **~J\$1.2B** for financial year ended March 31, 2019 and adjusted net profits of **\$76.99M**. The Company's Managing Director is Noel Dawes (Maj.) a retired member of the Jamaica Defence Force. Major Dawes is also a member of the company's six-member Board of Directors.

In August 2019 the Lumber Depot entered into an Intragroup Reconstruction Agreement with Blue Power in which Blue Power agreed to transfer all the assets of the Hardware Business as a going concern to the Company, and in return for the assets Lumber Depot agreed to assume all the liabilities of the Hardware Business and pay to Blue Power the excess of assets over liabilities.

With this offer, the LD is inviting applicants to subscribe for 141,247,500 new shares at the offer price of **J\$1.20 in an initial public offering (IPO)**. **If successful**, the company will apply for a listing on the JSE's Junior market.

## Summary of Offer

Lumber Depot Limited is seeking to raise **J\$169,497,000** through the issuance of **141,247,500** ordinary shares to prospective investors through an Initial Public Offering (IPO) at a price of **J\$1.20** each. After a successful completion of the IPO the Company will apply to the Jamaica Stock Exchange (JSE) for the shares to be listed.

Arranger	Mayberry Investment Ltd.
Issuer	Lumber Depot Ltd.
Securities	Up to 141,247,500 units of shares (General Public up to 70,623,750 and Reserved Shares up to 70,623,750)
Offer Price	J\$1.20
Exchange	Jamaica Stock Exchange, Junior Market
Stock Currency	Jamaica Dollars
Proceeds of IPO	J\$169,497,000
Open Date	November 22, 2019
Close Date	November 29, 2019
Use of Proceeds	(i) Payment to Blue Power Group for the transfer of the hardware business (ii) Working capital and for general corporate purposes (iii) Expansion of hardware business
Proposed Dividend Policy	The Board expects to pay annual dividends out of net profits available for distribution, subject to the need to maintain funds to re-invest earnings for growth, and for regulatory purposes.



## Expected Changes after Reorganization

The Lumber Depot Ltd. operates from its single location on Gordon Town Road. Given that the property is owned by the Cotrade Ltd.<sup>1</sup>, no rental fee was previously charged. Accounting services for the company were handled at the group level and the salaries of the Chairman and a Senior Manager were assigned solely to the Soap Division.

After the carve out of the lumber division, BPG will make several changes including:

1. Establishing a rental rate for the Lumber Depot Ltd.
2. Allocating a charge for accounting and storage services used by Lumber Depot Ltd.
3. Removing salaries for Group Chairman and General Manager from LD.

The Board of Directors of Lumber Depot Limited will consist of six members: Mr. Jeffrey Hall, Maj. Noel Dawes, Ms. Lisa Kong, Ms. Symone Mayhew, Lieutenant Commander George Overton and Mr. Vikram Dhiman. Mr. Jeffrey Hall will be the Chairman of the Board and each Director will receive a stipend of **~\$300,000** per annum.

## Company Analysis and Valuation

### Industry Analysis

The retail hardware sector in Kingston and St. Andrew is very competitive. The entities within the sector range from small hardware merchants to the larger home improvement centers. The Lumber Depot Ltd. operates from its single location on Gordon Town Road and has at least nine competitors within five miles and approximately twenty competitors within ten miles of its store. The main competitors include H&L True Value (three locations), Phil's Hardware, Tools Hardware (three locations), Budget Supplies Ltd. and Super Value.

H&L True Value and Super Value are the closest of the main competitors and both companies have their store in the Liguanea area (within 2 miles). LD's closest competitors, however, are Guthrie's Hardware and Barry's Hardware both within one kilometer of Lumber Depot's store but both operate on a much smaller scale.

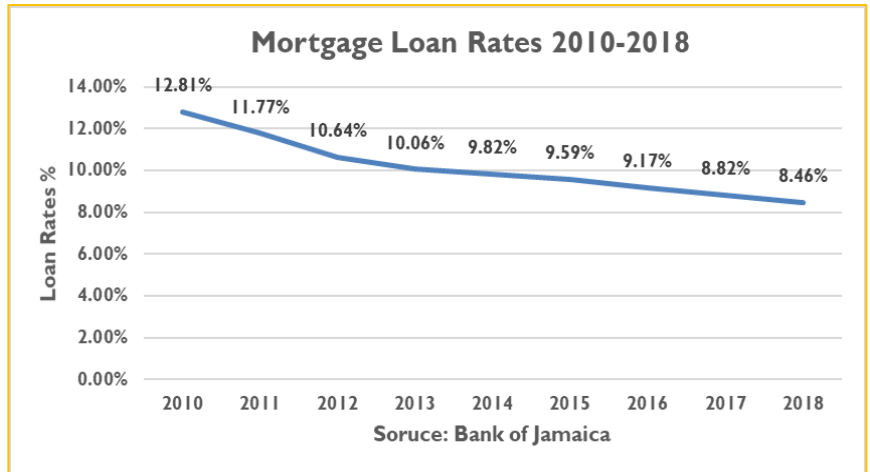
While Lumber Depot has customers from all over Kingston & St. Andrew, most of its customers are from East Rural St. Andrew (Gordon Town, Mavis Bank etc.), Papine, August Town, Kintyre and Dallas Castle.

<sup>1</sup> Cotrade Limited is a company incorporated under the laws of Jamaica with its registered office at 4 Victoria Avenue, Kingston CSO. Cotrade Limited is controlled by Blue Power Group Limited.



The Construction sector contributes approximately 7.2% of the country’s GDP annually and with the accommodative stance of the Government of Jamaica we expect to see further growth in the industry. Among the developments leading to the expected growth in the construction sector are:

- 1. **Low interest rate environment** – The Bank of Jamaica overnight policy lending rate of 0.50% is the lowest it has been in the last fifty 50 years. The knock-on effects of the low rates include low lending rates for businesses and consumers. Additionally, In The 2019/2020 budget debate the Finance Minister, Dr. Nigel Clarke announced that in addition to increasing the loan amount for first time home owners borrowing through National Housing Trust (NHT), the mortgage rates for the various categories of borrowers were also reduced.
- 2. **Reduction of Transfer Tax Rate** - The Minister lowered the transfer tax charge on certain properties from 5% to 2%.
- 3. **Adjustment to the Stamp Duty Charge** – Stamp duty was previously assessed ad valorem is now charging a flat rate of J\$5,000 instead of a percentage of the property value.
- 4. **Relaxed lending policies** – several mortgage institutions are now allowing the borrowing of up to 100% of the cost for residential properties.



These developments are expected to increase the demand for housing, especially within the context of a chronic under supply of new houses. A total of 15,000 new houses are required each year until 2030 to clear the backlog of demand for housing while only ~4,456 are being produced on average<sup>2</sup>.

<sup>2</sup> Ministry of Water and Housing [MWH, 2011]



## Investment Positives

**Supportive Macro Environment:** The local macroeconomic environment has improved steadily since 2013. These improvements have resulted in greater consumer confidence. In the report for the first quarter of 2019, the consumer confidence index was 177.5 points compared to 175.5 points recorded in the last quarter of 2018<sup>3</sup>.

As consumer confidence increases and in the context of improvements in several macroeconomic indicators, including unemployment rate which is now at **7.8%** along with interest rates which are very low, the expectation is that the demand for building materials will increase.

Additionally, the amendments passed to reduce transfer tax on properties to **2%** from **5%** should also translate into an increase in demand for housing over the medium term. The knock-on effect should be that there is uptick in new construction or renovation as older buildings change hands.

**Proximity to large Customer base:** Located on Gordon Town Road, the Lumber Depot is the largest hardware store serving the large communities of East Rural St. Andrew. Although there are other large players within ten miles, the added transportation cost for prospective customers to move goods from its competitors acts a deterrent. Additionally, commercial businesses in the area include two universities and a hospital.

**Low Rates on Corporate Loans:** One of the knock-on effects of the reduction in interest rates is that businesses can now access credit at relatively low rates including mortgages rates. One of Lumber Depot's challenge has been its inability to store all its inventory in the Gordon Town road. With rates being low, it means the company may be in a better position to access business loans to facilitate the purchase of space within its proximity or capitalize on other opportunities.

<sup>3</sup> Market Research Services on behalf of the Jamaica Chamber of Commerce (JCC).



## Investment Negatives

**Industry Fragmentation:** The industry within which LD operates is extremely fragmented. Additionally, information about the competitive landscape is usually not available for each competitor. As a result, Lumber Depot may not be able to assess its performance on a relative basis and may be forced to look at internal metrics such as revenue and profit growth and may not be able to assess when they are losing market share for example.

**Increase Import Cost Due to Trade Tension:** While Jamaica may not be directly targeted in the trade war, several products imported from US and China may be impacted. To the extent that the trade impasse will increase the cost of those items, Jamaican importers such as LD may feel some effect. Additionally, the ongoing tensions could destabilize the global economy resulting in a reduction in consumer confidence.

### **Increase Financial Risk:**

Over the last three years the company has taken steps to remove assets from its Lumber Division to its other division. As a result, this strategic decision effectively makes Lumber Depot financially weaker. The smaller asset and equity base reduce the Company's position to absorb any negative effects of disruptions in business activity. These disruptions could include increase competition, regulation etc.

**Lack of Adequate Storage Capacity:** Currently the Lumber Depot uses a Victoria Avenue facility as additional storage. This facility is approximately 9.7KM<sup>4</sup> away from its Gordon Town road location and means the company must factor this transportation cost in the operations. The company's ability to pass through these costs to customers may be constrained due to the competitive environment. However, LD may be able to access funding from the capital markets however given the fact that interest rates are at an all-time low which may be used acquire more suitable storage space for the company.

**Cyclical Nature of Business:** The retail business is cyclical in nature. Consequently, the business depends on the final consumer demand and the demand is driven by consumer confidence. When consumer confidence gets weak, they tend to reduce their spending until the confidence is regained. The ebbs and flows in consumer demand therefore may have a similar impact on LD's profitability. However, LD over its life has been through several economic cycles and this provides some comfort that they will be able to survive another turn in the cycle.

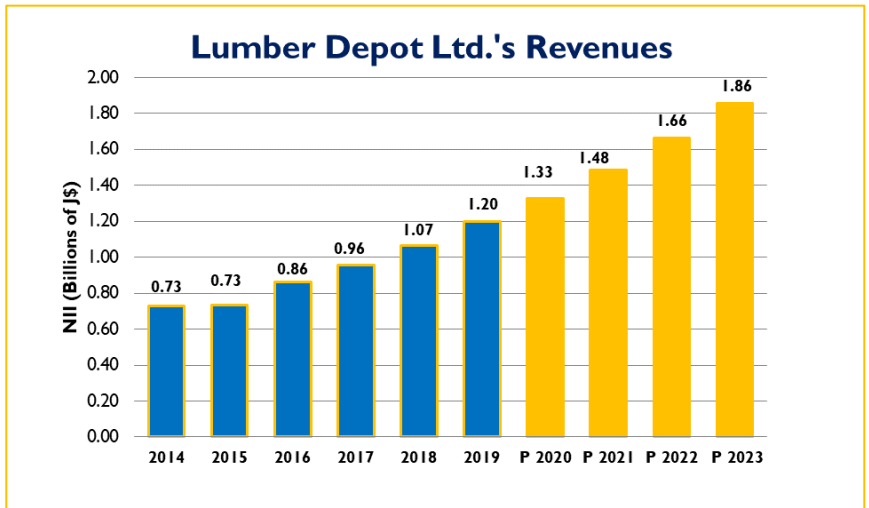
<sup>4</sup> Source – Google Maps



## Financial Analysis

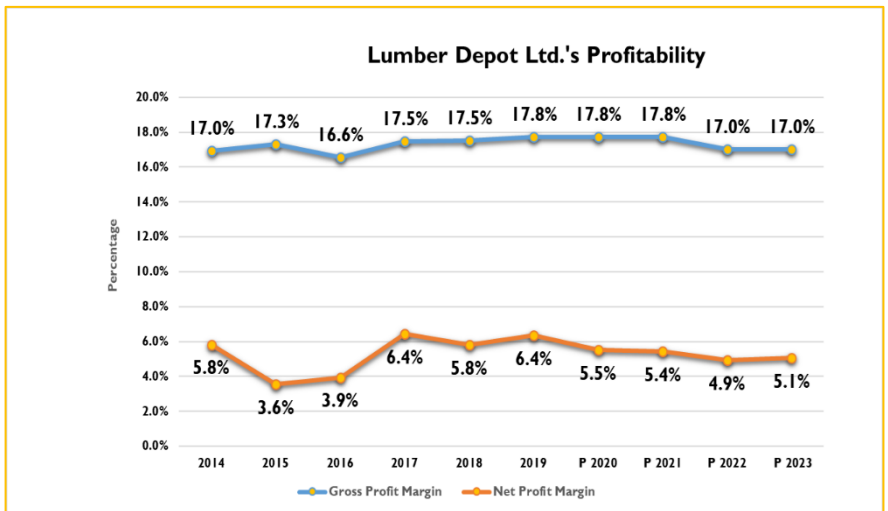
### Revenue & Profitability

Over the five years under review (2014-2019) the Lumber Division realized revenue growth at a CAGR of **10.46%**, moving from **J\$730M** posted in 2014 to **J\$1.20B** in 2019. Our projection is that the company should continue to experience relatively robust sales growth especially within the context of improving macroeconomic picture and the recent amendments by the Government of Jamaica to reduce transfer taxes on certain properties. We project that LD will generate



revenues of **~J\$1.33B** for the FY 2020 and this is expected to grow to **J\$1.86B** by 2023, which represents a CAGR of **11.77%**. The directors, in consultation with outside experts, have decided that there is room for the LD to grow but the growth will be better realized with the separation the two divisions.

From 2014 to 2017 the company had been able to maintain a gross margin **~17%** and this inched up to **~18** in 2018 and 2019. We however project that the company's gross margin will gradually decrease to reflect the long run average of **17%** by 2021 and continue through to 2023.



Operating Expenses for the Lumber Division has grown at a CAGR of **6.87%** from 2014 to 2019. Over the period, Staff salaries accounted for **~60%** of Total Operating

Expenses. As all the Chairman's and a Manager's salaries were allocated to the Lumber Division an adjustment was made in 2019 to reflect their salary at the group level. This decision resulted in a reduction of Staff Salaries share of the total expenses to **~45%**. Going forward, we expect salaries to remain the largest contributor to expenses, but the proportion of salaries



to total expenses should average ~45% through 2023. Another significant change in the expenses from 2020, is that the company will now incur rental charges for the main location at Papine and the storage facility at Victoria Avenue, and is projected to pay rent of ~**J\$21.29M** in 2020 and this grows to ~**J\$25.36M** in 2023. Overall, operating expenses which amounted to **J\$87.56M** in 2014 climbed to ~**J\$122.06M** as at April 2019 and is projected to grow to **J\$214.37M**.

The Lumber Division has been able to maintain a net profit margin of ~5.32% on average over the 5 years leading to 2019. In 2019, the company realized a net profit of **J\$76.16M**<sup>5</sup>. Net profit for the company is projected to decline to **J\$73.23M** in 2020 reflecting the new charges for rent which is expected to be borne by the company and amount to **J\$94.88M** or Net Profit Margin of ~5.11%.

## Asset Quality, Liquidity and Solvency

The Lumber Depot had been consistently growing its assets from 2014 to 2017. Over the period, Total Assets grew at a CAGR of ~19.39% or from **J\$258.82M** to **J\$525.87M**. The company's Asset base declined drastically in 2019 however, when it fell by ~56.58% to **J\$228.36M**. As at September 30, 2019 LD had Cash and Cash Equivalents of **J\$57.46M** which had risen from the **J\$21.10M** it stood at August 31, 2019.

As at September 30, 2019 Lumber Depot Limited had Current Liabilities amounting to **J\$202.60M** on its balance sheet. The largest current liability items were amounts due to Blue Power Group which was **J\$123.45M** and payables of **J\$69.14M**. The Company has stated that it intends to pay off ~**\$111.90M** of the amounts owed to the BPG with the proceeds of the IPO. The Company's Non-current liabilities amount to **J\$65.49M** as at September 30, 2019 and included a Long-Term Loan of **J\$25M** and Long-term lease liability of ~**J\$40M**.

The company's equity grew at a CAGR of 21.32% between 2014 to 2017 but saw a large decline 2018 to 2019 of ~62.33% falling from **J\$462.14M** to **J\$174.07M**. As at September 30, 2019 the company's equity stood at **J\$14.37M**.

<sup>5</sup> Net profit adjusted to reflect the transfer of the Chairman & Manager's salary to BPG





## Valuation

We decided to use two valuation methods to determine a fair value for Lumber Depot shares.

1. The first method used, was a present value model based on the Free Cash Flow to Equity (FCFE). The FCFE method was selected, as the Lumber Depot has not paid any dividends to date and no clear dividend policy has been set out in the prospectus. Our Free Cash Flow to Equity method produced per share value for LD of **J\$1.17**. When compared to the **IPO price of J\$1.20 per share it suggests that the IPO is priced at a small premium of ~2.56%**.
2. The second method used was a market-based, Price to Earnings (P/E) valuation where our aim was to value the company based on how similar companies were valued in the local market. Based on the P/E method, the per share value derived for Lumber Depot was **J\$1.87**. This value implies that the offer price is at a **35.83%** discount to our fair value estimate.

To arrive at a final fair value price for the Lumber Depot Ltd.’s shares we took an average of the two methods and determined that the fair value of the company’s share is **J\$1.52**. This implies that an IPO price of **J\$1.20** is a discount to fair value of **~21.05%**.

Valuation Method	Per Share Value J\$
Market Based/Relative Value	1.87
Present Value/Cash Flow	1.17
<b>Average Value Per Share</b>	<b>1.52</b>



## Conclusion

The Lumber Depot operates as a hardware store located in Papine (Gordon Town Road), which is the last major stop before entering the communities of East Rural St. Andrew. The hardware has been in existence for over twenty years and as a result has developed a large customer base of repeat customers primarily from communities including Papine, Gordon Town, Kintyre and Liguanea.

The Company has consistently posted return on equity (ROE) of over **10.00%** and net profit margin on average of **~5.32%** from 2014 to 2019. We are of the view that given their competitive position, plans and the changes announced during the 2019/2020 budget, to reduce transfer taxes on properties along with the lowering of NHT mortgage loan rates and the general economic environment, the LD is well positioned for future growth.

Based on the foregoing, we believe the Lumber Depot share price of **J\$1.20** is undervalued based on our fair value estimate of **J\$1.52** which reflects a P/E of **13.8X**. The fair value estimate represents a 1-year a return of **26.67%**. Therefore, we recommend Lumber Depot Ltd. as a **BUY** with a **Moderate** risk rating.



# Appendix

## Financial Statements Extract

Lumber Depot										
Income Statement 31st April										
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
	J\$'000	J\$'000	J\$'000	J\$'000	J\$'000	J\$'000	J\$'000	J\$'000	J\$'000	J\$'000
	Actual	Actual	Actual	Actual	Actual	Actual	Projection	Projection	Projection	Projection
<b>Revenue</b>	728,029	734,754	860,184	955,896	1,067,226	1,196,972	1,328,639	1,483,559	1,661,731	1,855,315
<u>Cost of sales</u>	- 604,608	- 607,554	- 717,676	- 788,666	- 880,121	- 984,485	- 1,092,779	- 1,220,197	- 1,379,237	- 1,539,911
<b>Gross profit</b>	<b>123,421</b>	<b>127,200</b>	<b>142,508</b>	<b>167,230</b>	<b>187,105</b>	<b>212,487</b>	<b>235,861</b>	<b>263,362</b>	<b>282,494</b>	<b>315,403</b>
Other income	7,651	5,882	12,221	23,953	11,279					
<b>Administrative and General Expenses</b>										
Advertising and promotion	419	4,314	4,206	4,658	1,282	1,623	4,156	4,640	5,198	5,803
Audit fees & professional fees	2,922	3,811	4,669	5,450	7,017	14,919	8,718	9,734	10,903	12,174
Bad debt	- 758	- 2,358	- 3,654	- 4,149	- 222	- 2,926	-	-	-	-
Bank charge & Fees	3,040	3,589	3,439	3,583	4,486	5,429	5,657	6,316	7,075	7,899
Heavy equipment rental/ maintenance	2,535	2,479	4,529	3,513	3,062	3,805	4,837	5,401	6,050	6,755
Insurance	2,537	3,158	3,965	4,397	3,591	4,485	5,337	5,960	6,676	7,453
Loss on disposal of asset										
Miscellaneous	145	3	42			34				
Office Expenses	1,485	2,358	2,177	4,076	3,131	2,914	3,856	4,305	4,822	5,384
Other expenses	323	1,410	3,115	4,154	2,025	245	-	-	-	-
Rental							21,291	22,569	23,923	25,358
Repairs & Maintenance	1,280	794	1,009	1,841	2,092	1,547	4,483	7,811	6,107	5,323
Salaries and wages	55,187	65,117	68,448	74,158	83,332	63,126	70,070	78,240	87,637	97,846
Statutory contributions	12,798	9,847	11,040	17,141	14,292	7,197	17,970	20,065	22,475	25,093
Security	2,809	2,837	3,008	3,032	3,275	3,501	4,513	5,040	5,645	6,303
Taxes, penalties and levy	137	619	744	852	621	762	887	990	1,109	1,239
Travel and motor vehicles	427	401	353	1,231	1,595	6,916	2,237	2,498	2,798	3,124
Utilities	2,275	2,338	1,898	1,808	2,478	2,625	3,304	3,689	4,132	4,614
<b>Total Operating Expenses</b>	<b>87,561</b>	<b>105,433</b>	<b>116,296</b>	<b>125,745</b>	<b>132,057</b>	<b>122,055</b>	<b>157,316</b>	<b>177,260</b>	<b>194,550</b>	<b>214,367</b>
<b>EBITDA</b>	<b>43,511</b>	<b>27,649</b>	<b>38,433</b>	<b>65,438</b>	<b>66,327</b>	<b>90,432</b>	<b>78,544</b>	<b>86,102</b>	<b>87,944</b>	<b>101,036</b>
<u>Depreciation</u>	- 1,065	- 1,335	- 3,848	- 3,377	- 4,310	- 5,065	- 5,318	- 5,584	- 5,863	- 6,157
<b>EBIT</b>	<b>42,446</b>	<b>26,314</b>	<b>34,585</b>	<b>62,061</b>	<b>62,017</b>	<b>85,367</b>	<b>73,226</b>	<b>80,518</b>	<b>82,081</b>	<b>94,879</b>
<u>Finance cost</u>	-	- 222	- 734	- 549	-	-	-	-	-	-
<b>Profit Before Tax</b>	<b>42,446</b>	<b>26,092</b>	<b>33,851</b>	<b>61,512</b>	<b>62,017</b>	<b>85,367</b>	<b>73,226</b>	<b>80,518</b>	<b>82,081</b>	<b>94,879</b>
<b>Tax</b>	-	-	-	-	-	- 9,208	-	-	-	-
<b>Net Profit</b>	<b>42,446</b>	<b>26,092</b>	<b>33,851</b>	<b>61,512</b>	<b>62,017</b>	<b>76,159</b>	<b>73,226</b>	<b>69,361</b>	<b>82,081</b>	<b>94,879</b>



## LUMBER DEPOT'S BALANCE SHEET EXTRACT

Millions of J\$

	2014	2015	2016	2017	2018	2019
<b>Non-Current Assets</b>	27,365	32,350	28,663	38,451	83,727	24,678
<b>Current Assets</b>	231,453	269,904	339,661	373,007	442,140	203,679
<b>Total Assets</b>	258,819	302,254	368,324	411,458	525,867	228,357
<b>Current Liabilities</b>	45,527	53,725	62,381	42,058	63,240	53,793
<b>Non-Current Liabilities</b>	-	-	-	490	490	490
<b>Total Liabilities</b>	45,527	53,725	62,381	42,548	63,730	54,283
<b>Shareholders' Equity</b>	213,292	248,529	305,943	368,910	462,137	174,074

## KEY FINANCIAL STATISTICS

	2014	2015	2016	2017	2018	2019
<b>Gross Margin</b>	16.95%	17.31%	16.57%	17.49%	17.53%	17.75%
<b>Operating Efficiency Ratio</b>	5.98%	3.76%	4.47%	6.85%	6.21%	7.56%
<b>Net Profit Margin</b>	5.83%	3.55%	3.94%	6.44%	5.81%	6.36%
<b>Return on Equity</b>	20%	11%	12%	18%	15%	24%
<b>Return on Asset</b>	16%	9%	10%	16%	13%	20%