Company Analysis: Fontana Pharmacy Limited (FTNA) 6M 2022/23

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- Stock Recommendation: **OVERWEIGHT**
- Price Target: **$11.95**
- Current Price: $8.32

- Shares Outstanding: 1,249,374,825 units
- Financial Year End: June 30

ABOUT THE COMPANY

The first Fontana Pharmacy was opened on November 30, 1968, at the Manchester Shopping Centre in Mandeville by Shinque (Bobby) Chang and his wife Angela. Fontana's core business remains the sale of pharmaceutical products, but it has diversified its offering to include 'brand Jamaica' products, health, beauty and cosmetic items, household essentials, toys, school supplies and electronics among other product categories.

Today, the company's operations have expanded to six pharmacy and retail store locations in St. Andrew (Barbican & Waterloo Square), St. James (Fairview), St. Ann (Eight Rivers Town Centre) and Westmorland (Beckford Plaza, Savanna-La-Mar). The company also operates an online shopping platform, which serves customers across the island and abroad.

Fontana disclosed that it is investing more than $100 million in a new location in Portmore by 2023 that will employ upwards of 80 Jamaicans. It will be in proximity to Braeton Parkway and Municipal Drive, adjacent to the new PriceSmart, and will become the chain's seventh store in Jamaica.

FINANCIAL PERFORMANCE SUMMARY

J$'000	FY 2020/21	FY 2021/22	6M 2021/22	6M 2022/23
Revenue	5,151,940	6,343,077	1,854,561	2,134,726
Cost of Sales	3,203,802	4,083,488	1,137,283	1,297,778
Net Profit	512,327	606,199	248,836	323,805
Total Assets	3,470,537	4,551,376	4,796,767	5,003,210
Total Liabilities	1,665,302	2,389,817	2,806,506	2,555,201
Total Equity	1,805,235	2,161,559	1,990,260	2,448,009

Dividend Policy

FTNA doesn't have a definitive dividend policy but has paid out on average $0.18 per share over the last two financials years after issuing $0.16 per share in 2020/21 and $0.20 per share in FY 2021/22.

Outlook

As the residual effects of the pandemic and the current high interest and inflationary environment begin to wane, we believe that Fontana's operations are likely to receive a boost. Also, a private placement of $500 mil was raised in September 2022, not only to facilitate the building out of the Portmore location but to expand FTNA's warehousing and distribution capacity. This is expected to boost company earnings, reduce long-term cost, and afford FTNA the opportunity to expand its customer base.

Projections and Valuation

Using the average of a Discounted Cash Flow model with a required rate of return of 14.7% and a P/E multiple of 18x we arrived at a target price of **$11.95.**

Risks to Price Target

The risk of not innovating and paying attention to industry trends could affect the bottom-line albeit a possible expansion in 2023. Also, If the current economic environment has lasting effects, severely decreasing consumer and business confidence, then the company may face challenges in maintaining its revenue streams and profitability.

SIX MONTHS ENDED DECEMBER 31, 2022

For the six months ended December 31st, Revenues increased by 15.1% from $1.85 billion to $2.13 billion. These results were achieved despite the continuous global supply-chain challenges impacting company operations. Cost of Sales grew at a slightly slower pace by 14.1% to $1.29 billion from $1.13 billion resulting in a gross profit of $836.94 million over the period which resulted in a 16.6% increase of the Gross Profit Margin to 39.21% as at the end of the reporting period.

Operating expenses grew by 35.3% to $490.47 million, up from the $391.52 million recorded in the same period of the prior year. Increased staff costs associated with the current operating environment and growth in staff compliment due to the opening of a new warehouse were the main drivers of operating expense. Despite the increase in Operating Expenses, Operating profit grew by 6.3% to $346.47 million.

Finance costs fell by 42.8% to $53.91 million primarily due to reductions in interest-bearing liabilities, namely, the current portion of Bank loans payable, current portion of lease liabilities, bank loan payables and lease liabilities. Net Profits for the period rose by 30.1% to $323.80 million (EPS: $0.49), from the $248.83 million (EPS: $0.41) recorded in the prior year. The company performed well given fluctuations in both consumer and business confidence which resulted in a 60-basis point increase in net profit margin to 5.3% as at September 30,2022.

FTNA's Asset Base increased by 4.3% to $5.00 billion due to improvements in Intangible assets, Inventories and receivables which grew by 35.7%, 28.6% and 11.4% respectively.

Total Liabilities fell notably to $2.55 billion from $2.80 billion or by 8.9% due to reductions in the current portion of Bank loans payable, current portion of lease liabilities, bank loan payables and lease liabilities which fell by 41.2%, 13.6%, 89.8% and 10.1% respectively.

Total Equity rose by 23.0% to $2.44 billion solely due to 26.3 % growth in accumulated profits. Debt-to-Equity fell notably to 66.3% from 94.3% as the business reduced its level of leverage significantly. Also, FTNA's liquidity position has improved and remains healthy with a current ratio of 3.08x.

OUTLOOK:

Continued acceleration of Digital Sales Channels

The pandemic sparked an acceleration in the digital transformation of many companies, including Fontana. The company continues to implement alternative sales channels including delivery and online offerings, providing options for E-commerce customers. Also, the business has continued to maintain key partnerships, namely, BlinkSky, a digital gifting platform, to launch Jamaica's first ever digital gift card. This allows for the sending and redemption of gift cards digitally. Through this service, customers can purchase gift cards for a wide range of popular international brands.

Further Expansion of Products Offered and Locations

FNTA continues to make efforts to penetrate new markets and customer segments which was evidenced by the introduction of the Craft market and Waterloo branch expansion. The company has commenced the construction of its Portmore Branch and has invested over US$1 million in the project. This bodes well for the business, as the company will be able to unlock revenue growth opportunities from Portmore's underserved population. This will likely create more jobs opportunity both for residents in Portmore and persons in neighbouring parishes, as Portmore aims to become a parish. In addition, by increasing the local footprint, the company is also providing more jobs in a fast-developing parish where a large fraction of the working Populus resides.

INVESTMENTS POSITIVES

- FTNA has experienced significant year-over-year growth in revenues over the past five years since listing on the JSE. (CAGR 14.4%)
- The company continues to benefit from the JSE Junior Market tax concession which allows it to retain more of its earnings for future growth or increased dividend payments.
- The demand for prescription and over-the-counter drugs continues to be steady and bodes well for revenue generation.
- FNTA continues to demonstrate strong brand awareness, good customer service and rewards and loyalty programs which will likely lead to increased customer retention.
- Despite operating in a highly competitive industry with relatively low to medium barriers of entry, FTNA has the largest market share.
- FTNA has relatively high levels of liquidity which telegraphs that the business has sufficient liquid assets to meet all of its short-term obligations.
- The addition of the Portmore branch in late 2023 bodes well for increased earnings as well as aide in job creation as Portmore transitions to Parish status in the near future.

INVESTMENTS NEGATIVES:

- Sharp upswings in the price of the US dollar could potentially cause the company's costs to increase, namely shipping costs and the cost of inventory.
- Disruptions in supply chain can lead to shortages or delays in the availability of products.
- The expiration of patents for certain pharmaceutical drugs may cause generic alternatives to enter the market which often leads to a significant reduction in price i.e., lower profit margins.

CONCLUSION

Fontana has been able to record consistent revenue growth despite the residual effects of the pandemic and the current high interest and inflationary environment. Given the current performance, we expect that demand will remain relatively stable as the company continues to reap the benefits of its Waterloo branch. We anticipate that further growth will occur as its seventh (7th) store is opened in Portmore this year, as well as through a more diverse product offering channel.

The company continues to manage its expenses well which has allowed for revenue growth to flow through to its bottom line. Additionally, the company paid improved dividends over the last two financial years (2020/21: $0.16 per share and 2021/22: $0.20 per share) which is a huge buffer on the first two dividend payments since listing in January 2019 (2018/19: $0.03 per share and 2019/20: $0.04 per share).

Using a discounted cash flow method, with a required rate of return of 14.7% and a long-term growth rate of 8.0% which is in line with current inflation, we arrived at a value per share of FTNA of $11.06. Assuming a P/E of 18x, in line with FTNA's peer group average, we arrived at fair value of $12.83. This results in an average price of $11.95, which is a 43.6% upside from current levels. Given these considerations, we recommend that investors **OVERWEIGHT** FTNA in their portfolio.

SOURCES

The Jamaica Stock Exchange, Fontana Annual Reports and Quarterly Financials, Loop News Jamaica, The Jamaica Observer, The Jamaica Gleaner

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- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
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