VM Wealth Management Limited

Company Update: Future Energy Source Co. Ltd. (FESCO) Q1 2024/25 Analysis

VMWM Research, Business Planning & Investor Relations | November 23, 2024

876-960-5000 | vmwmclientservices@myvmgroup.com | vmwealth.myvmgroup.com | 53 Knutsford Boulevard, Kingston 5

- Stock Recommendation: **OVERWEIGHT**
- Price Target **$4.03**
- Current Price: **$3.73**

- Shares Outstanding: 2,500,000,000 units
- Financial Year End: March 31

ABOUT THE COMPANY

FESCO is a Jamaican owned, fuel distribution company, licenced and operating in Jamaica. FESCO was incorporated and registered with the Companies Office of Jamaica on February 4, 2013, as a private limited liability company and made its first fuel sale in November 2013. In 2014, FESCO's first branded Service Station was unveiled in Mandeville (Heaven's FESCO) and has since grown to twenty-one (21) branded Service Stations Island wide, accounting for over 8% of the local fuel industry, with over 80 staff members.

The service stations in the chain are operated under either a 'dealer-owned, dealer-operated' or 'dealer-owned, company-invested' or 'dealer-owned, company-operated' model or 'company-owned, company-operated'.

In April 2023, FESCO acquired the liquefied petroleum gas (LPG) business assets of Wilson Beck LPG Limited (WB), to support the advancement of the company's goals for entering the cooking gas market under the FESGAS brand. The acquisition was financed by a prior $700 million bond raise. The company launched FESGAS, a cylinder that offers enhanced safety compared to traditional gas cylinders due to the incorporation of No-BLEVE technology, eliminating the risk of boiling liquid expanding vapor explosion incidents on July 6, 2023.

FINANCIAL PERFOMANCE SUMMARY

JMD ('000)	FY 2021/22	FY 2022/23	Q1 2023/24	Q1 2024/25
Revenue	26,282,166	28,680,617	6,562,175	7,779,959
Operating Profit	566,400	594,706	159,790	185,808
Net Profit	571,267	410,816	115,741	148,371
Total Assets	3,826,777	5,315,120	4,288,996	5,287,250
Total Liabilities	2,524,919	3,057,273	2,829,107	2,881,031
Total Equity	1,301,857	2,257,848	1,459,888	2,406,219

Dividend Policy

FESCO has a dividend distribution policy of cash dividends up to 25% of net profits twice per annum. Over the last five years, the company, on average, had a dividend payout ratio of 7%. The last dividend payment amounted to $0.016 per ordinary share paid in October 2022.

Outlook

Fuel price volatility remains high, albeit on a smaller scale than in 2023. However, the company is expected to expand its top line by increasing brand awareness of the FESGAS LPG business line, through collaboration with 7Krave, as well as the expansion of its LPG operations and four additional service stations. However, the company's financial performance may be negatively impacted by the entrance of electrical vehicles into the local automobile market, which may lower demand for petrol in the long term, but in the medium term the volatility in oil due to the ongoing Russia-Ukraine conflict may hamper growth.

Projections and Valuation

We used a Free Cash Flow to Firm model with a cost of equity of 9.60% and a weighted average cost of capital of 8.30% to produce an intrinsic price of $2.31. We also used a Market Comparable Approach using an implied P/E of 21x to arrive at a price of $5.55 and an implied P/B of 4.0x to arrive at a price of $4.22. When averaged together, we yielded a target price of **$4.03** per share**.**

Risks to Price Target

Due to the nature of the company's operations, FESCO's stock remains resilient. As a result, the stock price is anticipated to increase over the medium term, even though recession probabilities are decreasing, and prices are still high. We believe there are more upside risks than downside risks to our estimates.

FIRST QUARTER ENDED JUNE 30, 2024

For the first quarter ended June 2024, FESCO' s total revenues grew by 18.56% from $6.56 billion to $7.79 billion. Notable increases in the number of liters of fuel sold (including LPG) were reflected in FESCO's quarterly improvement in revenue. Additionally, the company has recognized benefits from increased brand awareness for FESGAS™ where it has maintained and enhanced market share for the LPG business line. With the opening of a new service station last month, FESCO Hayes (DOCO), and the separation from the DODO service station in Whithorn, Westmoreland, FESCO's branded service stations remain at twenty-one (21) island wide.

Cost of Sales remained high at $7.37 billion, reflecting a 17.60% increase as the company continued to expand. Similarly, operating and administrative expenses surged by 65.83%, which was directly related to four additional business operations in Kitson, Hayes, Bernard Lodge and Naggo Head. Business acquisitions' associated costs and costs related to the expansion of LPG operations and service station assets also added to total expenses, deteriorating the operating ratio marginally from 2.08% to 2.91%. The Company's LPG activity requires significant capital due to fixed asset needs for service provision and operation. Nevertheless, FESCO achieved its best quarter to date with gross profits totaling $412.28 million and recording a 38.71% increase.

A lower net finance income of $31.44 million resulted in Net Profit for the first quarter totaling $148.37 million, a 28.19% jump over the corresponding period in the prior year and benefiting from the allowable JSE Junior Market 5-year tax exemption. Earnings per share (EPS) grew from $0.046 to $0.059, reflecting the improvement in net profit.

As of June 30, 2024, total assets reached $5.87 billion, marking a 42.63% increase over the previous year. The 22.87% increase in Property, Plant and Equipment, accompanied by a 321.02% uptick in rights of use assets and a 320.14% increase in inventories, contributed to this growth. However, the return on average assets (ROAA) decreased to 8.99% due to assets growing faster than net profit. Total liabilities remained relatively flat at $2.88 billion during the first quarter. Notably, long-term loans declined by 13.33% to close at $1.48 billion when compared to the prior year over the similar period. FESCO's liquidity position slightly weakened with the current ratio slipping from 1.26x to 1.25x and the quick ratio from 1.22x to 1.07x. However, the company is still able to meet short-term payments. Retained Earnings surged by 32.57% to $1.63 billion, leading to a 64.82% jump in Shareholders' equity to $2.41 billion. Following this spike, the book value per share (BVPS) increased from $0.58 to $0.96. Because total assets and shareholders' equity outpaced total liabilities, the company's solvency remained stable, with the debt-to-equity ratio improving to 0.8x, and debt-to-capital ratio declining from 57.5x to 42.9x.

OUTLOOK

Expansion Plans

FESCO will continue to collaborate with 7Krave to provide customers with FESGAS household cooking gas via the 7Kravemart app. A wide range of FESGAS products are available to customers, including cylinder exchanges for the range of cylinders and new installations. Although FESCO's revenue is anticipated to benefit from industry and product diversification, the demand for LPG products is predicted to continue increasing. However, this strategy will require greater capital expenditure and higher operating expenses. The new FESCO Oval service station on Spanish Town Road is currently under construction. To boost retail presence in the Kingston and St Andrew area, this service station will be owned and operated by the corporation. Completion will take approximately 15 months, and it is set to open in September 2025.

Physical Expansions in the Medium-Term

Based on industry data, FESCO has surpassed Petcom as the largest locally owned gas station brand, but it still lags behind the giant, international petroleum marketing firms, whose networks are between double and quadruple its size. FESCO still operates 21 service stations across Jamaica. Through its FESGAS brand, which consists of two company-operated LPG filling factories and three service stations—FESCO Kitson Town, FESCO May Pen, and FESCO Port Maria—FESCO established and distributes its LPG. These expansions are expected to increase FESCO's market share in the fuel industry, strengthen brand awareness and further boost the company's financial performance.

INVESTMENT POSITIVES

- The recent opening of 3 new service stations is anticipated to grow and strengthen the customer base and result in a higher inflow of income.
- FESCO is currently trading below the industry's median P/E, suggesting that the stock may be currently undervalued, given the comparatively high ROAE and the company's growth prospects.
- The corporate tax exemption enjoyed by listing on the JSE Junior Market will eliminate the tax margin and allow the company to gain and retain higher profits, which can be used to reinvest and drive expansion plans.
- The company maintains a low cash conversion cycle, indicating that FESCO receives payments for sold goods before paying its suppliers. This highlights the company's effective operational efficiency with a relatively low operational efficiency ratio.

INVESTMENT NEGATIVES

- The introduction of electric vehicles to the local automotive market may see demand for fuel falling in the medium to long term and negatively impacting the company's financial performance.
- Despite the growth in assets, the ROAA has been steadily declining, which may suggest inefficient asset allocation that can stymie the company's growth.
- The moderately high-interest rate environment can increase interest expenses for future debt raises, which could negatively impact the company's bottom line.
- Market price volatility can pull the revenue line and cause the stock price to fall.

Company Update: Future Energy Source Co. Ltd. (FESCO)

VMWM Research, Business Planning & Investor Relations | November 23, 2024

CONCLUSION

Fuel price volatility remains high, albeit on a smaller scale than in 2023. However, the company is expected to expand its top line by increasing brand awareness of FESGAS LPG business line, through collaboration with 7Krave as well as the expansion of its LPG operations and four additional service stations. The company's financial performance may be negatively impacted by the entrance of electrical vehicles into the local automobile market, which may lower demand for petrol in the long-term, but in the medium-term the volatility in oil due to the ongoing Russia-Ukraine conflict may hamper growth.

We used a Discounted Free Cash Flow to Firm model with a cost of equity of **8.30%** and a weighted average cost of capital of **9.63%** to produce an intrinsic price of $2.31. We also used a Market Comparable Approach using an implied P/E of 21.0x to arrive at a price of $5.55 and an implied P/B of 4.0x to arrive at a price of $4.22. When averaged together, we yielded a target price of **$4.03** per share, which represents a 7.91% upside to the current trading price. As such, we recommend that investors **OVERWEIGHT** the shares in their portfolio.

SOURCES

Bloomberg, FESCO's Website (https://www.fescoja.com), IMF, FESCO's Financial Statements, JSE, Jamaica Gleaner, Jamaica Observer, PSOJ, Damodaran Website

DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **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.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.