Hardware & Lumber Limited
Company Analysis

Company Background

Hardware & Lumber Limited (H&L) is involved in the trade of hardware, lumber, household items and agricultural products and provides residential and commercial construction services.

The company, which is incorporated and domiciled in Jamaica is a 67% owned subsidiary of GraceKennedy Limited, which is also incorporated and domiciled in Jamaica. The company is listed under the retail sector on the JSE and has a market capitalization of $1.32 billion as at June 20, 2008.

As of August 1, 2005, GraceKennedy Limited, which took control of the company in June 2003, undertook the decision to reorganize the company and consequently, all of Hardware & Lumber's former subsidiaries with the exception of Wherry Wharves are in the process of being wound up.

Currently, Hardware and Lumber provides its products and services under three business segments namely, Wholesale and Projects division, Retail Household, and Agricultural Division.

Industry Analysis

Hardware and Lumber operates in a very competitive market. Over four hundred hardware stores offer direct competition in the retail business and approximately ten competitors exist in the wholesale business.

Hardware & Lumber's main competitor, particularly in its wholesale business is ARC. Mainland International which offers wholesale and retail services is another competitor but to a lesser extent.

The agricultural division that operates from five locations faces competition from Hi-Pro farm Store and Jamaica Live Stock Association (JLA). However, JLA operates the largest branch network with locations strategically placed in major agricultural regions in the island.

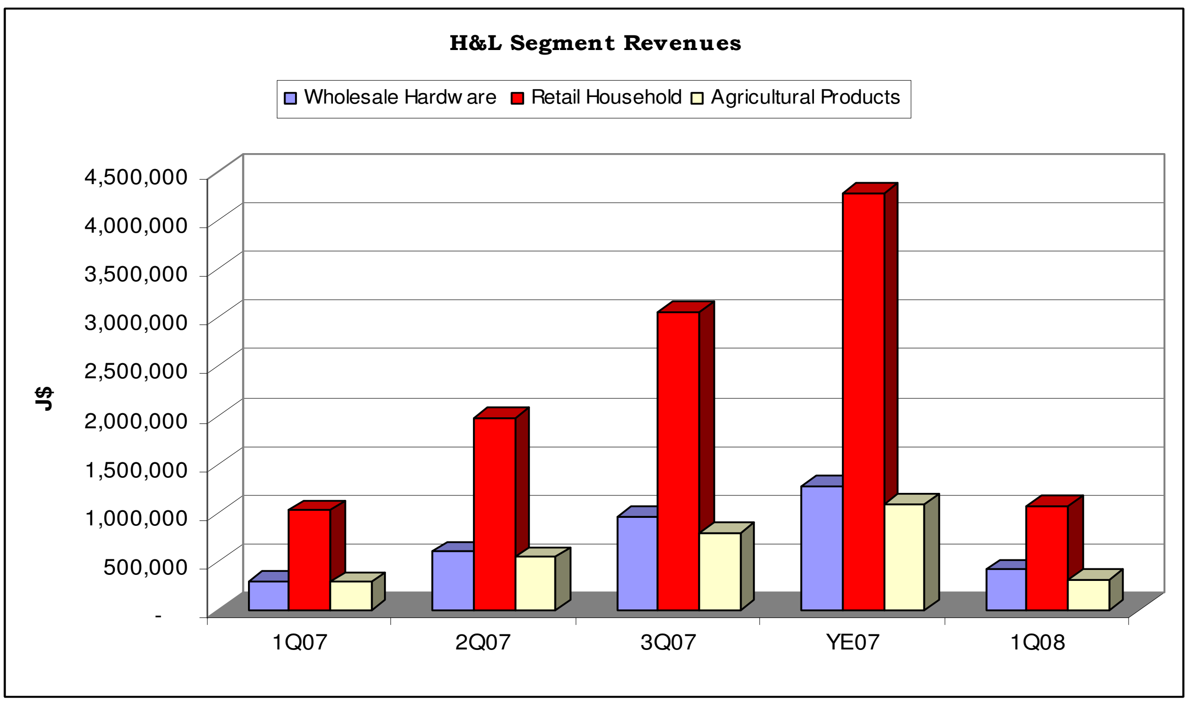
Segment Analysis

The Retail Household division continues to account for a significant portion of the company's revenue, due mainly to the distribution of its thirteen branches islandwide. See Figure 1. For the first quarter, this division accounted for approximately 60% of overall revenue. Revenue for the quarter increased only 4.08%. According to the company's CEO, the closure of the St Ann's Bay branch in March 2007, adverse effect of sluggish activity for construction material in certain market segments on sales and slow activity during the Easter holidays were the main reasons. Consequently, the company reported a 27.34% falloff in profit from operations within its Retail division.

The wholesale division's contribution to overall revenue was far lower at 23.18%, but during the period it grew by 43.00% and was the only division to record an improvement in profit from operations. This division recorded a 26.87% increase in profit from operations, owing to growth in existing and new market segments in the hotel industry as well as new housing schemes.

Although the agricultural division recorded an 8.49% increase in revenue, profit fell 29.23% to $7.96 million. The performance from this sector was affected by the increase in prices of fertilizer in the Agricultural sector.

Figure 1: Quarterly Business Segment Revenues



Fundamental Analysis

Table 1: Financial Statement Highlights for quarter ending March 2008

($'000)	Three-Months to Mar 2008	Three-Months to Mar 2007	% Change
Sales	1,789,539	1,598,945	11.92%
Cost of Sales	(1,340,313)	(1,204,428)	11.28%
Gross Profit	449,226	394,517	13.87%
Other Operating Income	5,887	10,214	-42.36%
Operating Expenses	397,972	341,798	16.43%
Operating Profit	57,141	62,933	-9.20%
Finance costs	(24,048)	(25,985)	-7.45%
Profit before Taxation	33,093	36,948	-10.43%
Net Profit	22,066	24,637	-10.44%
Earnings per Stock Unit	0.27 cents	0.30 cents	
Ratios			
COS: Sales	74.90%	75.33%	
Gross Margin	25.10%	24.67%	
Operating Margin	3.19%	3.94%	
Net Margin	1.23%	1.54%	
Total Assets	3,260,274	2,903,236	12.30%
Total Liabilities	2,026,944	1,711,792	18.41%
Current Assets	2,749,726	2,261,482	21.59%
Current Liabilities	1,668,790	1,465,678	13.86%
Shareholders equity	1,233,330	1,191,444	3.52%
Current Ratio	1.49X	1.54X	
Quick Ratio	0.49X	0.57X	
ROA	0.68%	0.85%	
ROE	1.79%	2.07%	

For the three month period ended March 31, 2008, Hardware & Lumber saw an 11.92% increase in revenue to $1.79 billion. All three divisions contributed to the improved results. The wholesale and Hardware divisions saw revenue growth of 43.00%, while the Retail Household and Agricultural divisions saw growth of 4.08% and 8.49% respectively.

Cost of sale for the quarter increased by 11.28% to $1.34 billion. Nevertheless, gross profit improved by 13.87% on the comparative quarter and amounted to $449.23 million. Likewise, gross margin, a measure of the company's profitability, improved slightly from 24.67% to 25.10%.

Owing to nonrecurring costs related to the implementation of the new software and other accounting related expenses, operating expenses grew by 16.43% to $397.97 million. This increase along with the significant 42.36% fall in other operating income to $5.89 million resulted in the company experiencing a 9.20% drop in profit from operations to $57.14 million. Similarly, there was a falloff in operating margin, which stood at 3.19%, coming from 3.94% last year.

With finance cost falling by 7.45% to $24.05 million, pretax profit settled at $33.09 million or 10.43% below the comparative period.

Net profit stood at $22.07 million, down 10.44%, which translated into EPS of $0.27 versus EPS of $0.30 in the comparative period.

Balance Sheet

Total assets grew by 12.30% to $3.26 billion, driven mainly by the 15.97% and 263.20% increases in intangible assets and inventories respectively. Liabilities also increased, but by a bigger 18.41% to $2.03 billion. Notably, long-term debt rose by 157.84% on the same period last year.

With respect to working capital, the growth in current assets exceeded the increase in current liabilities. But despite this, the Company's liquidity position deteriorated, as indicated by the fall in its current ratio from 1.54X to 1.49X. Since inventories, which may be fairly illiquid, are included in the current ratio, the quick ratio, another measure of the liquidity which excludes inventory is employed. Like the current Ratio, the quick ratio also showed a deterioration in the Company's liquidity position.

Due to the decline in net income relative to the same period last year, both return on asset and return on equity fell from 0.85% and 2.07% to 0.68% and 1.79% respectively. Table 1 summarizes the movement in the company's financial position.

SWOT Analysis

Strengths

- The Company is a major player in the Retail Business.
- The Group has 13 Retail stores that are strategically located in major towns across the island.
- Agro Grace is the dominant supplier of inputs to the agricultural sector, particularly in the crop sector.
- A special projects department was formed in the third quarter of 2006 to complement the operations of the wholesale division. The department's primary focus is to get business from construction projects. The department achieved sales of $39.5 million in 2006 and $214 million in 2007.
- The Company has strengthened its management with the employment of new managers in key areas such as supply chain management. Enhancing its supply chain management system will enable to company to better manage its inventory levels.

Weaknesses

- Credit risk associated with the Wholesale side of the business.
- Agricultural business is vulnerable to external shocks such as hurricanes.
- Revenue growth is seasonal across its Agricultural and wholesale business segments while expenses or overheads do not necessarily change accordingly.
- The company's ability to pass through increased costs is constrained due to the competitive environment in which it operates.

Opportunities

- Hardware & Lumber recently installed a new information management system, S2K, in order to achieve greater efficiency across all divisions. With this new software, the company can benefit from savings in the areas of procurement, distribution and customer service levels. The new IT platform should also minimize inventory buildup and increase turnover.
- NHT Housing starts up 16%, which should provide the company with the opportunity to boost its sales in the retail and wholesale divisions.
- The construction sector, which took a beating from the faulty cement crisis, has recovered with a 5.4% improvement and is projected to continue growing, at least in the second quarter.
- Improvements in its supply chain management process will enable the company to better manage its inventory levels.

- Opportunities exist for the company to try to boost revenue by having joint Hardware and Agro Grace Retail stores.
- The company intends to expand its retail operations in the near term. Demographic studies have already been completed. An increase in its retail outlets should increase revenue contribution from its largest revenue generating division.

Threats

- Likely external events such as hurricanes adversely affect the agricultural sector and may affect revenues in the Agricultural division. Past data also shows that during disaster periods, consumer spending patterns also slows which could have negative implications for the company's Retail Household business segment.
- The entry of new players, particularly in areas where the company operates, can impact negatively on its profit.
- The ease of entry and exit in the competitive industry within which the company operates can affect margins.
- The current inflationary environment should affect expenses in terms of wages and salaries as well as cost of goods.
- The company has increased its debt significantly by 157.84% in an environment where interest rates are likely to increase or at least remain high. This can have negative implications for its finance costs.
- The vast majority of the company's products are imported. With the global rise in commodity prices, such as oil and steel, the company's cost of imports is likely to increase.

Technical Analysis

Graph 1: Movement of H&L Stock Price over a 7-year period

Bloomberg monitor shows a raw beta of 0.91 and a positive adjusted beta of 0.94 between H&L and the stock market. Therefore, the stock price movement is likely to mirror that of the general stock market. The graph above tracked the movement of H&L's stock price from February 23, 2001 to June 20, 2008. During the earlier part 2008 for example, when the stock market stock market was experiencing an up tick, H&L's stock price appreciated accordingly, reaching its 52-week high of 20.00 on February 18, 2008. Similarly, when the stock market began to retreat H&L's stock price declined in much the same way.

Despite the fact that the stock price movement mirrors that of the general market, the stock is among the illiquid stocks on the JSE as it is closely held by its majority shareholders, GraceKennedy and Pan Jamaica. As a May 30, 2008, the JCSD top 50 shareholders listing shows that GraceKennedy and Pan Jamaica own approximately 71% of the outstanding shares. The remaining forty-eight shareholders accounted for approximately 24% of the outstanding shares.

Apart from the general confidence in the market, investors also show interest in the stock especially in light of the fact that H&L is constantly reorganizing in order to be more profitable and efficient. In looking at graph 1 above, it is seen that despite the fact that the stock's price has declined since the middle of 2005, its lows are above the levels seen prior to that period.

Graph 1 above also shows that the stock price is showing signs of appreciating as indicated by the rise in the 50 days moving average above the 100 days and 200 days moving average trend lines. A clearer picture of this movement is depicted in Graph 2 below:

Graph 2: Price and volume movement

Valuation Ratios

Current Price: $16.31 (June 20, 2008)
52 Week High/Low: $13.00/$20.00
Price Target: $23.95
Shares Outstanding: 80,842,023
Market Cap: $1.32B
Price to Book Value: 1.07X

Book Value/Share: $15.26
Current EPS: $1.58 (trailing EPS)
Five year average book value: 1.43X
Growth in equity: 9.77%
Projected Book Value: $16.75

Recommendation

Hardware and Lumber operates in a highly competitive industry. The company, over the years, has undertaken a number of reorganizing and re-branding exercises in order to strengthen its market position, which has positively affected its revenue movement. Since GraceKennedy took control of the company in 2003, revenue grew by over 151% (YE03 vs. YE07).

More recently, H&L restructured its supply chain management process, which will serve to enhance its inventory management. Additionally, it has implemented a new software, S2k, to improve on efficiency which by extension should reduce costs. Warehouses have been refurbished and an automation process will be implemented to complement the use of technology. This should also improve operational efficiency and overall management of the warehouse operations.

In late 2006, it expanded its wholesale division to include, special projects, with its primary focus being to generate new business and as such increase revenue. This division should continue to perform well, particularly due to the fact that it is not affected by seasonal changes. The Agricultural division may continue to suffer with the fallout in the agricultural sector, the rise in price of fertilizers and the sectors vulnerability to hurricanes.

In the area expansion, the company intends to increase its retail outlets in the short to medium term. Already, the retail division is the largest contributor to revenue and its contribution will therefore improve. This division should get support from the construction sector at least in the second half of the year. According to the PIOJ, the construction sector, which grew by 3.5% during the first quarter, will continue to impact positively on GDP during the second quarter. In the latter part of the year, increased spending during the yuletide season should improve revenue in this division.

With the above in mind we expect the company's revenue and profits to improve despite the current domestic economic challenges coupled with the rise in price of commodities.

In valuing the stock, the Price to book valuation method is employed since the company has a huge amount of tangible current on its book. We have used the previous financial year's growth in shareholders equity of 9.77% (YE07vs.YE06). We consider this the normalized earnings growth and the most appropriate to use as it excludes the negative effect of the cement crisis on the company. With current book value of $15.26, we project a book value of $16.75 for the end of 2008 financial year.

Given the lack of similar listed company's, we are unable to determine a peer P/B ratio. Instead, we will use the company's average price to book (P/B) ratio over the last five year to determine the fair price of the stock. This P/B average is 1.43X.

The resultant target price is $23.95 and gives shareholders a potential return of 46.84% if the stock is bought at the current price of $16.31. The expected large movement in future stock price is justified, as its ownership concentration is very high, with primarily institutional investors. The stock is also fairly illiquid and with a bid/ask price of $16.30/$18.99, the stock price is expected to move by a wide margin. .

With expectations that the company will be resilient to present and future economic slowdown, and with ongoing implementations to further streamline its operations, as well as projected uptick in the stock price from the technical analysis, investors should opt to **BUY** this stock at the present time.