1/4/2021

Genomma Lab Investment Thesis

Introduction

Genomma Lab (LABB) is one of Mexico's leading companies in personal care (PC) products and over-the-counter (OTC) medications, with a growing international presence both in South America and the United States. At the time of publication, the reference price was 19.61 MXN, which corresponds to a ~$930 M USD market capitalization.

LABB is a good business that is cheap on the basis of its current operations, but what makes the opportunity compelling here is that the company is in early stages of what should prove to be a sustainable step-change in profitability. For the last few years, LABB has been investing heavily in a new manufacturing facility that will allow the company to consolidate its operations and generate meaningful margin improvement from the attendant cost synergies.

We think this opportunity exists because Mexico tends to be an underfollowed market, and only investors that have taken the time to "look around the curve" will understand that LABB is on the cusp of a meaningful inflection.

Company Background

History

A good summary of LABB's (quite unique) past can be found here; the first key paragraphs are reproduced below:

"The company that is now Genomma Lab was originally founded in 1996 by a group of three close friends as a consumer marketing company focused on television infomercials: Producciones Infovisión. Shortly after beginning operations, Producciones Infovisión developed its own television production capability to produce infomercials for beauty care products. In doing so, the founding team recognized an opportunity to develop and market its own line of products, and in 1999 the company was reorganized into a vertically integrated product development and marketing platform.

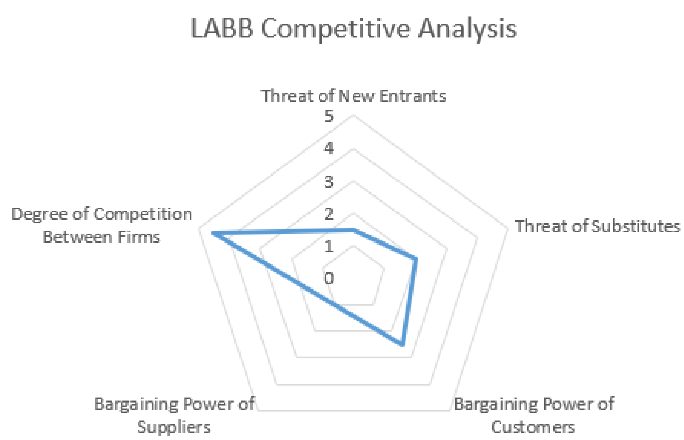
Changing its name to Genomma Lab, the company began building a network of distributors and mass merchandisers. A few years later, Genomma Lab expanded its product portfolio to include over-the-counter (OTC) pharmaceuticals and began selling through drug wholesalers."

In 2004, LABB sold a 30% stake to a private equity fund in order to raise capital to support its growth. The success of this expansion (during which the company moved into 12 countries and grew sales at a 35%+ CAGR) prompted the company to go public in 2008. Following a rocky first few months in the throes of the financial crisis, the stock eventually appreciated over 350% from its IPO price on the back of continued strong growth. Their PE investor fully exited in 2011, having realized an 18.5x return on its investment.

Unfortunately, LABB's attempt at further expansion eventually led it to get out over its skis, and by 2014, the company was having severe cash conversion issues. Founder Rodrigo Herrera was nudged out of the CEO role, and to right the ship, the company undertook a painful destocking process under new leader Max Juda. The significant restructuring expenses this entailed led the stock to lose around two-thirds of its value by the end of 2015, but it was ultimately successful. In recent years, LABB has once again set new sales records while maintaining a much healthier and more sustainable financial profile (to be discussed more below).

Industry & Business Quality

We mentioned above that LABB is fundamentally a good business, and much of that can be traced back to its industry environment. As most readers already know, the consumer-packaged goods (CPG) and OTC medication industries are both generally attractive. In each, firms tend to enjoy stable pricing, a predictable cadence of demand, and a lack of compelling substitutes (what else can you use to wash your hair besides shampoo?). Significant capital requirements and limited market size expansion deter new entrants, and LABB has 459 suppliers – a level of diversification that inhibits the power of any individual one. Certain large retail chain customers may have some negotiation power, but LABB is large enough that any concession is still likely to result in a mutually beneficial arrangement. The biggest issue tends to be industry rivalry stemming from the relatively large number of competing firms, and with HHI scores generally well below 1,000 in most of its markets, this is indeed the case for Genomma. A simplistic summary of these dynamics is provided below.



Like most other CPG companies, LABB's competitive advantages stem from brand loyalty and the breadth of its distribution. The company's products sell not only in all of the largest Latin American retail chains, but also in many small stores in rural areas thanks to LABB's investments in direct distribution. In all, there are now more than 300,000 points of sale. Aside from its continued hold on the top spot in market share across many of its key products, customer loyalty can be seen via the company's sizable social media engagement – LABB has 2.3 M Instagram followers; by comparison, P&G and Walmex have 103x and 50x more sales, but only 154k and 325k followers, respectively.

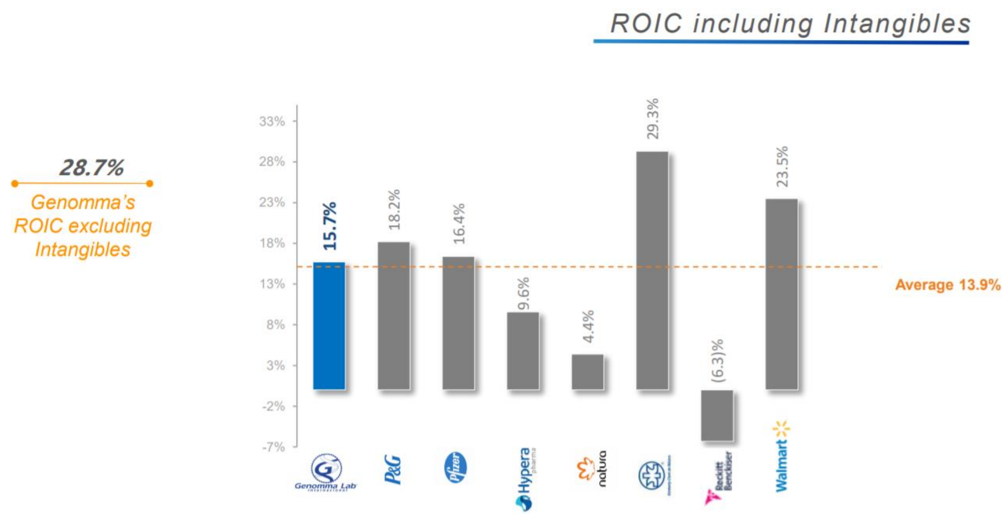
For the foreseeable future, we can expect above-GDP industry growth driven by increased purchasing power among emerging market consumers (benefitting discretionary personal care product demand) and aging populations (benefitting OTC product demand). Additionally, the small-ticket nature of its items and their tendency for habitual usage limit price sensitivity, meaning LABB should be able to continue pushing through minor price increases if it so chooses. Both of the above have contributed to LABB's success in recent quarters even amidst a difficult economic environment (see below):

Period	GDP Growth[1]	Net Sales Mexico[2]	EBITDA Mexico[2]
2Q' 2019	(1.1)%	+12.1%	+51.6%
3Q' 2019	(0.4)%	+14.1%	+35.5%
4Q' 2019	(0.7)%	+11.6%	+50.3%
1Q' 2020	(1.3)%	+9.7%	+76.0%
2Q' 2020	(18.7)%	+5.0%	+7.7%
3Q' 2020	(8.6)%	(0.7)%	+19.4%

The capital-intensive nature of manufacturing does mean LABB has a significant fixed cost base, but the risk from this is offset by the predictable nature of its products' demand and its minimal reliance on volatile external inputs. The significant investments made in its new manufacturing facility in recent years also serve to greatly reduce the likelihood of PP&E obsolesce or disadvantage for the foreseeable future. Moreover, significant operating leverage should begin to kick in the next few quarters as the company ramps up production on its just-completed Personal Care production line and starts to realize cost efficiencies from its new centralized footprint.

Capital Efficiency and Economic Profitability

Thanks to all of the above factors, LABB enjoys strong ROA (roughly 7%) and ROE (16%) ratios. Its metrics for each, along with its returns on invested capital, are roughly in line with the industry (see chart below). Since the company is not regularly acquisitive, its 29% ROIC excluding intangibles is perhaps more representative of the company's status going forward.



Just as important as LABB's historical metrics, we think the pro forma financial profile is compelling. Following the completion of its new facility, we estimate LABB will have spent around 1.9 B MXN to generate 485 M in incremental FCF, representing very attractive return. Putting together these returns and the reinvestment rate, we estimate LABB will have grown intrinsic value by about 35% over the last three years despite the stock being down 7% over the same period.

We also quickly note that Genomma's 13-14% CFROI and 0.7x asset turnover suggests a relatively balanced split between production and consumer advantage. Emerging market firms in its industries have around an 9.5% discount rate, implying LABB is comfortably profitable on a true economic basis.

Management & Insiders

Insiders own 28% of the company, with the lion's share of that attributable to founder and current board chairman Rodrigo Herrera. The company has nine board members, six of whom are independent. While there are several members with familial ties to the founders, the high level of insider ownership does ensure an alignment of incentives.

Current CEO Jorge Brake assumed his role in 2018 as part of a planned transition from Max Juda after the company completed its turnaround process. While Brake had been working in another industry (education) prior to accepting the job, he had previously spent 25 in the Latin American business of P&G, eventually ascending to chief executive of the region. Since he assumed the role, LABB has consistently highlighted its new product releases and portfolio optimizations in its financial material, along, of course, with progress updates on facility construction.

Customers and Employees

A check of product reviews reveals that Genomma's products are well-regarded by end consumers as a whole, with pain relief products enjoying particularly favorable ratings. Given that Genomma is diversified across 18 countries, 40 brands, and a wide range of retailers, there is no customer concentration risk. Employee reviews are generally positive as well, especially in the compensation/benefits category. With a 100% approval rating out of 56 reviews, it's clear that CEO Jorge Brake's message and leadership is resonating throughout the organization.

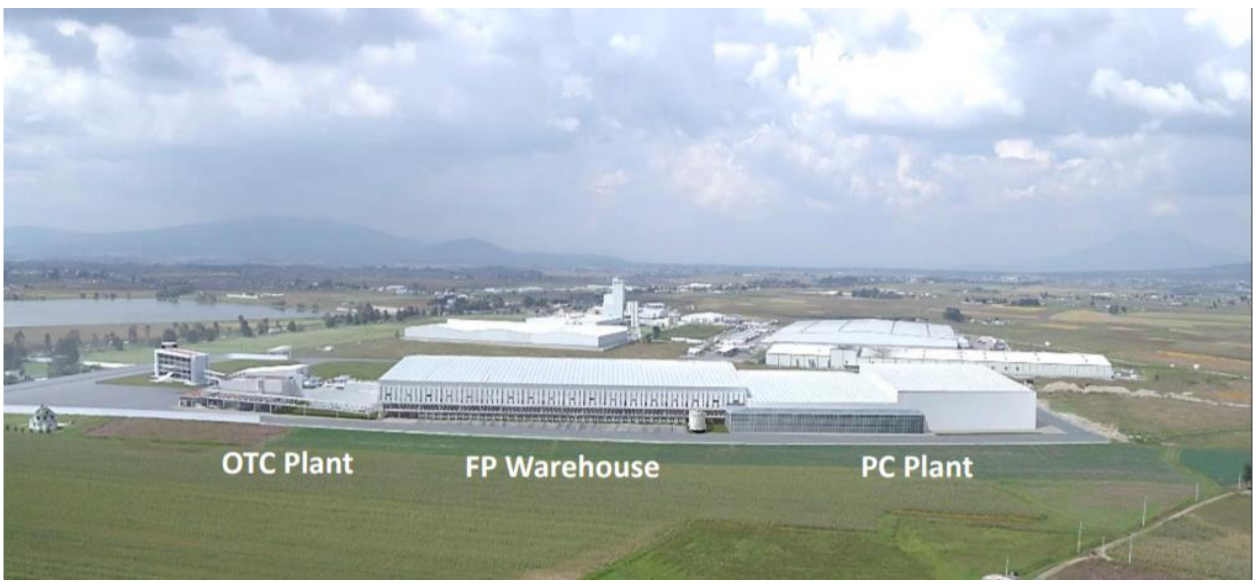
Profitability Inflection – the Reason to Invest Now

Prior to 2020, LABB's gross and operating margins had modestly compressed over time, largely due to a combination of product, channel, and geographic mix changes. However, they have rebounded in recent quarters thanks to cost saving initiatives (Q3 EBITDA margins saw 230 bps expansion on a YoY basis), and they remain largely in line or superior to peers on the whole (see below):

Company Name	Gross Margin	EBITDA Margin	EBIT Margin	Net Margin
Genomma Lab B	61.6%	20.9%	19.5%	10.3%
Average	**48.9%**	**22.2%**	**18.0%**	**7.6%**
Median	**54.8%**	**26.9%**	**23.0%**	**8.8%**
Procter & Gamble	51.5%	27.5%	23.4%	18.9%
Hypera	62.4%	27.0%	24.0%	32.0%
Natura & Co Holding	58.0%	11.7%	3.8%	-2.5%
Kimberly Clark de Me...	38.5%	26.8%	22.6%	12.9%
Reckitt Benckiser Group	60.3%	29.3%	25.9%	-20.2%
Wal-Mart de Mexico	22.9%	10.8%	8.3%	4.6%

While LABB's margins are already solid, the central part of the thesis here is the potential for significant further expansion as the new manufacturing plant removes production inefficiencies. Supplier facilities are currently unsynchronized with warehouses scattered throughout the country, creating both inefficient logistics and higher baseline inventory requirements. One example provided by the company below shows how its bottles are currently produced in one city and then must be transported long distances across state lines via truck to actually be filled:

The new facility consolidates production in both business segments in a single facility, with the two manufacturing plants connected via a finished goods warehouse (see rendering below).



The facility ramp has been delayed from the initial plans of a 2019 launch, first due to delayed receipt of permits and then from pandemic upheaval. While it's unclear how much blame the company deserves for the permitting holdups, few would find fault in LABB's inability to stick to a schedule for labor that cannot be done virtually in the midst of an epidemic, particularly in the country which has suffered the highest death rate in the world from COVID-19. The fact that COFEPRIS (the relevant Mexico regulatory authority) paused all site visits for GMP certification (a required step for OTC certifications) also meant production wouldn't have been able to commence even if the buildout were to be completed on schedule.

Though a good portion of these delays were outside the company's control, they may have nevertheless created investor fatigue in the name and led to the opportunity here today. Fortunately, these issues are now largely in the rear-view mirror, as production is now underway in the PC plant as the OTC facility awaits final certification from COFEPRIS, which restarted inspections in late summer.

Upon completion, LABB expects to achieve around 7% annual cost synergies, of which half will be reinvested into growth initiatives[1]. As we will see later, this incremental 3.5% has a significant impact on the company valuation profile.

Valuation

Multiples

Given that Genomma's focus on health and wellness is consistent across its business, and because of the lack of detailed segment-level disclosure the company provides, a consolidated valuation is most appropriate here. FCF and EBITDA-based enterprise multiples, along with P/E ratios, are generally the most applicable to CPG firms. On that basis, one can see that LABB remains cheap relative both to peers...

Company Name	Price to Earnings Actual	Price to Earnings NTM	PEG Ratio	Enterprise Value/ EBITDA	EV/ EBITDA NTM	Enterprise Value/ EBIT	Enterprise Value/ Sales
Genomma Lab B	14.15x	11.99x	0.57x	8.92x	7.38x	9.58x	1.87x
Average	**23.05x**	**28.52x**	**4.22x**	**16.20x**	**13.98x**	**25.81x**	**3.52x**
Median	**21.82x**	**22.50x**	**3.13x**	**16.37x**	**14.40x**	**19.62x**	**3.63x**
Procter & Gamble	24.99x	24.00x	3.51x	17.27x	16.79x	20.28x	4.75x
Hypera	15.47x	15.52x	1.41x	18.60x	13.36x	20.95x	5.03x
Natura & Co Holding	-	66.85x	-	21.28x	15.44x	65.11x	2.50x
Kimberly Clark de Me...	18.64x	18.85x	1.97x	10.14x	9.82x	12.07x	2.72x
Reckitt Benckiser Group	-	21.01x	11.11x	15.47x	15.54x	17.47x	4.53x
Wal-Mart de Mexico	33.08x	24.92x	3.13x	14.44x	12.94x	18.95x	1.57x

[1] Given the initiatives are captured on the statement of cash flows as capex rather than as an operating expense, current profitability metrics are unaffected by the facility buildout.

… and to its own historical trading multiples:

Importantly, these metrics include no upside from the step-change in profitability that should occur upon final facility completion.

Financial Model & Target Price

A snapshot of our financial model is provided below. Assuming modest margin expansion starting in 2021 upon completion of its facility and continued sales growth, LABB should generate around 3.5 B MXN in EBITDA. At a 10x multiple, this works out to a value of around 33 MXN per share for 2021, implying 66% upside and a 50% IRR from the present price. Assuming most of the margin benefits are realized by 2022 while giving virtually no credit to potential sales acceleration from the portion of savings to be invested in growth initiatives, it's not unreasonable to think the stock could roughly double within two years.

In a bear case where margin improvements fail to materialize in a timely manner, we think our downside is limited. Sales growth coupled with leverage reduction as facility buildout costs wane will eventually drive the already low multiples still lower, which will eventually be compensated for in equity value. A share repurchase facility that has been consistently (albeit modestly) acted upon could provide further support for the stock; we would expect it to be accelerated if the valuation gap continues to widen.

Shares	950.3	
x Price	19.61	MXN
MC	18,635	
+ Debt	6,499	
- Cash	1,568	
EV	23,566	
		928
2018 PT:	19.89	
IRR	*2.8%*	
2019 PT:	20.26	
IRR	*3.3%*	
2020 PT:	26.00	
IRR	*75.8%*	
2021 PT:	32.58	
IRR	*40.3%*	
NTM PT:	30.93	
IRR	*57.7%*	
USD/MXN	20.07	

	2015	2016	2017	2018	2019	2020	2021	2022
Revenue	11,042	11,316	12,078	11,794	12,713	13,857	14,758	15,496
x Gross Margin	*69.7%*	*72.1%*	*67.2%*	*65.8%*	*63.7%*	*62.4%*	*64.0%*	*64.5%*
Gross Profit	7,692	8,159	8,121	7,765	8,098	8,640	9,445	9,995
- Operating Expenses	5,776	5,872	5,715	5,464	5,767	5,813	6,139	6,291
EBIT	1,916	2,287	2,406	2,301	2,331	2,827	3,306	3,703
+ D&A	118.2	82.3	68.9	81.2	142.2	152.4	162.3	170.5
EBITDA	1,798	2,205	2,475	2,382	2,473	2,979	3,468	3,874
x Multiple	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
EV	17,980	22,051	24,747	23,823	24,730	29,793	34,681	38,739
- ND	4,457	3,992	3,614	4,459	4,467	4,166	4,043	2,351
MC	13,523	18,059	21,133	19,364	20,263	25,626	30,638	36,388
/ Shares Out.	1,014.6	951.3	951.3	950.3	945.0	942.2	939.4	936.6
Value	13.33	18.98	22.22	20.38	21.44	27.20	32.62	38.85
Upside	*-32.0%*	*-3.2%*	*13.3%*	*3.9%*	*9.3%*	*38.7%*	*66.3%*	*98.1%*
IRR	*-32.0%*	*-3.2%*	*13.3%*	*3.9%*	*9.3%*	*92.4%*	*50.2%*	*35.5%*
EBITDA Margin	*16.3%*	*19.5%*	*20.5%*	*20.2%*	*19.5%*	*21.5%*	*23.5%*	*25.0%*
Debt Balance	6,183	5,838	4,707	5,873	6,035	5,734	4,043	2,351
IC	12,380	10,451	11,063	12,648	14,181	15,174	16,236	17,373
EBIT ROIC	*15.5%*	*21.9%*	*21.7%*	*18.2%*	*16.4%*	*18.6%*	*20.4%*	*21.3%*
FCF ROIC	*8.0%*	*12.5%*	*12.5%*	*9.9%*	*8.9%*	*10.6%*	*12.8%*	*14.3%*

	2015	2016	2017	2018	2019	2020	2021	2022
EBITDA	1,798.0	2,205.1	2,474.7	2,382.3	2,473.0	2,979.3	3,468.1	3,873.9
- D&A	118.2	82.3	68.9	81.2	142.2	152.4	162.3	170.5
- Interest	372.0	296.7	443.4	522.9	577.9	602.1	424.5	246.9
- Taxes	392.3	547.8	588.7	533.5	549.5	667.4	864.4	1,037.0
NI	915.5	1,278.2	1,373.7	1,244.8	1,203.4	1,557.3	2,016.9	2,419.6
/ Shares Out.	1,014.6	951.3	951.3	950.3	945.0	942.2	939.4	936.6
EPS	0.90	1.34	1.44	1.31	1.27	1.65	2.15	2.58
x Multiple	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Value	13.53	20.16	21.66	19.65	19.10	24.79	32.21	38.75
Upside	*-31.0%*	*2.8%*	*10.5%*	*0.2%*	*-2.6%*	*26.4%*	*64.2%*	*97.6%*
IRR	*-31.0%*	*2.8%*	*10.5%*	*0.2%*	*-2.6%*	*59.8%*	*48.7%*	*35.4%*

2017	2018	2019	2020	2021	2022	
6.7%	-2.4%	7.8%	9.0%	6.5%	5.0%	growth

1.1%	of sales	
10.6%	CAGR	
10	EV/EBITDA	<-- 10 yr. median is around 11x

2019	2020	
-0.6%	-0.3%	annual dilution

**includes intangibles*		
7.0%	IC growth	
32.6%	2015-2020 EBIT ROIIC	
22.3%	2015-2020 FCF ROIIC	
10.5%	WA IR	
30%	effective tax rate	
<-- sometimes lower than statutory Mexican rate (30%) due to NOLs		
12.9%	CAGR	
15	P/E	<-- 10 yr. median is around 15x

	2015	2016	2017	2018	2019	2020	2021	2022		
NI	915.5	1,278.2	1,373.7	1,244.8	1,203.4	1,557.3	2,016.9	2,419.6		
+ D&A	118.2	82.3	68.9	81.2	142.2	152.4	162.3	170.5		
- Maint. Capex	42.6	55.0	65.0	75.0	85.0	95.0	100.0	105.0		
uFCF	1,251.5	1,513.3	1,687.9	1,616.9	1,665.1	2,036.2	2,376.4	2,657.9	10.2%	CAGR
x Multiple	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5	14.5	EV/uFCF
EV	18,147	21,942	24,475	23,446	24,144	29,525	34,457	38,539		
- ND	4,457	3,992	3,614	4,459	4,467	4,166	4,043	2,351		
MC	13,690	17,950	20,861	18,987	19,677	25,359	30,414	36,188		
/ Shares Out.	1,014.6	951.3	951.3	950.3	945.0	942.2	939.4	936.6		
Value	13.49	18.87	21.93	19.98	20.82	26.91	32.38	38.64		
Upside	*-31.2%*	*-3.8%*	*11.8%*	*1.9%*	*6.2%*	*37.2%*	*65.1%*	*97.0%*		
IRR	*-31.2%*	*-3.8%*	*11.8%*	*1.9%*	*6.2%*	*88.4%*	*49.4%*	*35.2%*		

	2015	2016	2017	2018	2019	2020	2021	2022		
FCF	991.1	1,305.6	1,377.5	1,250.9	1,260.6	1,614.8	2,079.2	2,485.0		
+ Maint. Capex	42.6	55.0	65.0	75.0	85.0	95.0	100.0	105.0		
CF	1,034	1,361	1,443	1,326	1,346	1,710	2,179	2,590	10.6%	CAGR
x Multiple	14.0	14.0	14.0	14.0	14.0	14.0	14.0	14.0	14	P/CF
MC	14,472	19,048	20,196	18,563	18,838	23,937	30,509	36,261		
/ Shares Out.	1,014.6	951.3	951.3	950.3	945.0	942.2	939.4	936.6		
Value	14.26	20.02	21.23	19.53	19.93	25.41	32.48	38.72		
Upside	*-27.3%*	*2.1%*	*8.3%*	*-0.4%*	*1.7%*	*29.6%*	*65.6%*	*97.4%*		
IRR	*-27.3%*	*2.1%*	*8.3%*	*-0.4%*	*1.7%*	*67.8%*	*49.7%*	*35.3%*		

	2015	2016	2017	2018	2019	2020	2021	2022		
FCF	991.1	1,305.6	1,377.5	1,250.9	1,260.6	1,614.8	2,079.2	2,485.0	10.3%	CAGR
x Multiple	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15	P/FCF
MC	14,867	19,584	20,663	18,764	18,909	24,222	31,188	37,276		
/ Shares Out.	1,014.6	951.3	951.3	950.3	945.0	942.2	939.4	936.6		
Value	14.65	20.59	21.72	19.75	20.01	25.71	33.20	39.80		
Upside	*-25.3%*	*5.0%*	*10.8%*	*0.7%*	*2.0%*	*31.1%*	*69.3%*	*103.0%*		
IRR	*-25.3%*	*5.0%*	*10.8%*	*0.7%*	*2.0%*	*71.9%*	*52.4%*	*37.0%*		

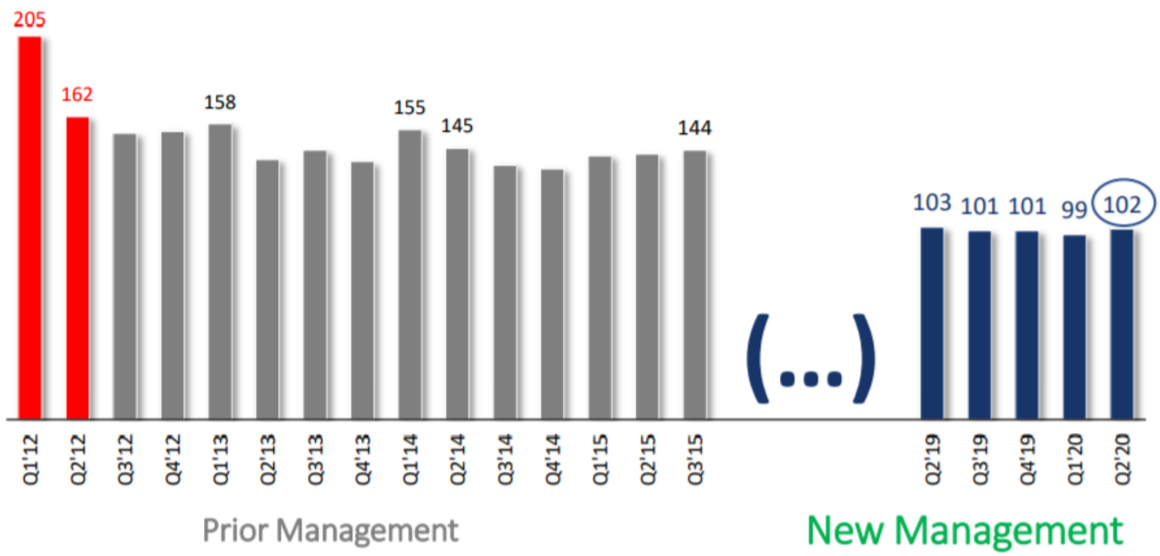
	2015	2016	2017	2018	2019	2020	2021	2022		
Total FCF	991.1	1,305.6	1,377.5	1,250.9	1,260.6	1,614.8	2,079.2	2,485.0		
- FCF for Dividend	-	-	-	-	-	-	-	-	$ -	annual dividend
- FCF for Buyback	272.3	1,087.7	4.0	133.9	99.3	10.3	53.7	53.5	19	avg. repurchase price
- Growth Capex	-	30.8	75.3	1,348.6	747.5	400.0	221.4	232.4	1.5%	of sales reinvested
- FCF for M&A	(966.1)	83.6	233.6	166.6	14.9	1.6	-	-		
FCF for ND Reduction	1,684.9	103.5	1,064.6	(398.1)	398.9	1,202.9	1,804.1	2,199.1		

Given the business quality and free optionality here, we think the range and skew of outcomes is very attractive. The stock is already cheap under its current earnings power, and even more so looking out a few quarters following margin expansion after the completion of its facility. In our experience, it's rare to find a potential two-year double in such a straightforward consumer staples business.

A Few Other Housekeeping Items

Net debt/EBITDA currently stands at 1.9x, which is comfortable given the industry dynamics and roughly in line with the company's long-term averages. LABB completed both a successful refinancing and capital raise in 2019 and also issued an unsecured bond earlier this year that was over 2x oversubscribed, suggesting that it retains financial optionality if for some reason it became necessary. Given the company has made it through the pandemic requiring neither, we view that as very unlikely going forward.

As discussed above, LABB has done an excellent job improving its financial efficiency in recent years, cutting its cash conversion cycle by nearly 40% while taking working capital out of the business under new management (see chart below). FCF available for debt reduction will further increase in the coming quarters as the investments required for the new production facility (currently running a bit over 100 M MXN per quarter) wind down.



We also note that LABB does not use any adjusted metrics in its financial reports and does not add back currency fluctuations or exceptional costs from the facility buildout. Given the significant expenses being incurred on that front, no one can accuse the company of underinvesting.

Risks

If we're wrong, it will likely be because the new production facility doesn't ramp up as quickly or as effectively as planned. As discussed, there have been some delays from the initial ramp-up plans (thanks in large part to the pandemic), but the personal care production lines are now in operation while OTC operations remain imminent. There does not seem to be any reason why the approvals will not be given, but the process remains unfinalized for now. The risk of further strengthening of the USD relative to the peso would also be detrimental, given Mexico's sluggish recent economic growth.

A longer-term risk worth monitoring is the growing prominence of direct-to-consumer (DtC) personal care brands. In the US, certain PC brand start-ups have been successful by upending the traditional supply chain and using online channels to bypass traditional distribution methods. While this is usually more problematic for retailers than manufacturers, as DtC concepts tend to disrupt marketing and distribution more than anything else (the products need to be made regardless), the potential impact to margins from such a shift is worth monitoring.

Conclusion

Genomma Lab presents an opportunity to invest in a high-quality business at an attractive valuation. Even more importantly, it offers a risk-reward skew that is rare for a stable CPG-type company – double your money if things go as planned, but suffer little to no permanent capital impairment if not. Aligned insiders and a capable management team further improve the odds of a favorable outcome. LABB is currently flying under the radar of nearly all investors, but once margin expansion begins to show up in its financial results (or if emerging market equities come back into favor), we think shares will quickly rerate to 30+ MXN, which represents an attractive IRR and MOIC profile from the current price.

Catalyst

There is no hard catalyst present here, except for a significant improvement in profitability following the production facility's ramp and continued intrinsic value growth for many years after that.

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