Corporativo Fragua, S.A.B. de C.V. (FRAGUA.BMV)

Mexico's Leading Pharmacy Convenience Retailer w/ Massive Footprint

Corporativo Fragua, S.A.B. de C.V. (FRAGUA) operates pharmacy stores under the Superfarmacia name in Mexico. FRAGUA is the best pure-play bet on Mexican drugstores. Mexico's largest pharmacy chain boasts 2,298 locations covering 418 cities, 32 states, and serving 612M Mexicans. Their next closest competitor, FEMSA Health, has 1,250 locations.

The company will benefit from two critical country-specific trends. First, Mexicans are living longer, with the average life expectancy projected to reach 80 years by 2050. Second, chronic disease is on the rise as people that live longer tend to develop more chronic health issues.

By 2050, KPMG estimates that Mexico's population will reach 150M people. Of that 150M, they expect 1/5th of the people or 30M citizens to be *at least* 60 years of age. This massive increase in the aging population brings with it increased healthcare spending, which means more money spent on prescription drugs.

Over the last decade, the company has grown revenues ~12% per year while slowly expanding gross margins from 18% to 20%. At the same time, they've increased EPS at an 18% CAGR from MXN 7.12 to MXN 19.85. All without issuing a single additional share or taking outside capital. Plus, the original Arroyo family continues to run the business to this day.

Yet despite this sustained earnings growth and robust business model, the company trades for 0.3x NTM sales and 12x NTM earnings.

There are a couple of reasons why the stock trades so cheap. First, the company operates in Mexico, which has been a dead trade since 2013. The Mexico ETF (EWW) has returned -33% since 2013. Second, pharmacy stores are low margin, highly fragmented businesses. Your typical "great company" value screen won't pick it up.

FRAGUA can grow top-line revenue at high single-digits for the next five years by expanding stores and installing a third Distribution Center (DC). At ~8.5% annual revenue growth, FRAUGA could end 2025 with MXN 110B in revenue and MXN 2.82B in operating income. **That's good enough for a 10% yield at the current EV.**

The company's golden egg is its ability to reduce growth CAPEX spending. Once FRAGUA switches from growth to maintenance mode, the company will generate more free cash flow than it has in its entire lifecycle. These potential cash flows remain hidden behind a wall of growth spending.

Herein lies our opportunity. Most investors see a low-margin, highly competitive business. We see a company self-funding an aggressive expansion strategy with the potential to create massive sustainable free cash for decades to come. We get all that for below-market multiples and fractions of its annual sales.

Creating The SuperFarmacia Concept

FRAGUA began in 1942 as a simple pharmacy store providing essential pharmaceutical drugs and personal care. Over time, the company expanded its offering, selling food, drinks, and other miscellaneous consumer product like electronics, diapers, and clothing. Today, it splits its revenues between three segments: Health and Wellness (71.5% of revenue), Nutrition (21.5% of revenue), and Other Products (6% of revenue).

For non-Mexican members, it's best to think of FRAGUA as Mexico's CVS or Walgreens, where pharmacy meets convenience store.

These SuperFarmacias have everything a customer needs, many of which are located near high-density neighborhoods. This makes FRAGUA's stores a frequent stop for most consumers, especially those seeking prescription drugs.

What makes a SuperFarmacia great isn't the number of items each store sells. Instead, it's the immense distribution network associated with the large store footprint. FRAGUA has one of the largest distribution networks in the country, equipped with two (soon to be three) Distribution Centers and their owned logistics trucking fleet. A network *that* size creates serious competitive price advantages through **scale economics shared.**

The more stores FRAGUA builds, the greater negotiating power they have with their vendors. That negotiating power translates to consistently lower prices. This isn't a hypothesis, either. Multiple online reviews confirm that FRAGUA's drug prices are some of the lowest in the country and specifically lower than its closest competitor, Oxxo (FEMSA Health).

FRAGUA also buys its products directly from its vendor partners at a negative cash conversion cycle. This means FRAGUA doesn't pay its vendors until it gets cash from selling the product. Again, negotiating these types of deals *only works* at FRAGUA's scale. Mom-and-pop pharmacies don't have such luxuries.

A History of Self-Funded Growth

I love the FRAGUA thesis because it reminds me of similar ideas we've covered in the past. For example, Gym Group (GYM.LSE), Loungers (LGRS.LSE), and Hoteles City Express (HCITY.BMV) all shared one common characteristic: **they're spending a lot on growth which hides true cash flow potential**.

FRAGUA has self-funded its robust SuperFarmacia expansion since its IPO in 1997, opening at least 30 new stores a year for the last twenty-two years.

At some point, the company will reach capacity and switch from growth to maintenance spending mode. When that happens, FRAGUA will generate **significantly greater** FCF than it does now. Of course, we can't precisely determine *how much* FCF they'd generate without growth CAPEX, but we can guess. The company segregated its capital investments each of the last four years in its 2019 Annual Report:

- 2020 (projected): MXN 1.6B
- 2019: MXN 2.027B
- 2018: MXN 1.9B
- 2017: MXN 1.24B

The last three years of capital investments funded the expansion of 438 new stores. Let's assume that maintenance CAPEX is half of what FRAGUA spends on growth CAPEX. If that's true, **the company would have, on average, MXN 3.4B in freely available cash to return to shareholders or buy back stock per year.**

Such an influx of cash would translate into much higher ROIC, ROA, and ROE (FRAGUA generates ~5% ROA currently). At that point, 12x earnings would seem like a joke of a valuation.

The company broke ground on its third Distribution Center (this one in Hidalgo), so we shouldn't expect growth spending to slow any time soon.

What Makes FRAGUA Defensible?

The pharmacy/convenience store business is good if you have scale, which FRAGUA does in spades. Historically, industry margins are roughly 1-3%. Low operating margins should reduce competition from first-time entrants. However, competitors like FEMSA Health could try to outspend FRAGUA to capture most of the market and win the scale economics battle.

That said, I give the edge to FRAGUA within Mexico's borders. The company deals *exclusively* within Mexico. This allows it to develop unique, personal relationships with Mexican vendors and become the go-to distributor for local Mexican goods. Not to mention the real estate footprint they have in 400+ cities and 30+ states.

I'd imagine there's some NIMBYism happening with local SuperFarmacias as well. What's the incentive to place another pharmacy convenience store near a FRAGUA SuperFarmacia if FRAGUA offers lower prices on food and drugs?

Another advantage FRAGUA has over its peers is its loyal customer base. Most of the store reviews I found online were positive. Take a few comments from this YouTube video showing you the inside of a FRAGUA store (see below):

Pedro MM 1 year ago

They are open 24 hours a day, 365 days a year. This is very good especially if you require a medication or simply fulfill the whim of your pregnant lady

7 REPLY

Mushu PD 1 year ago

Pharmacy in a supermarket is much larger, they sell clothes, toys, pepperoni, fruits and vegetables, motorcycles, bicycles, appliances, electronics, furniture, everything for pets, food, clothing, etc., Mr. Roberto only went to the shelves, it has enough medicine, only that it was not exhibited, to fill a prescription. I miss the section, diapers, for children and adults. In medicine it has very good prices. Greetings

Show less

3 REPLY

Fons Veritatis 1 year ago

A Guadalajara Pharmacy always saves your life. Most of them open 24 hours. It is a super-pharmacy and you can find everything.

fifteen REPLY

Employees also seem to enjoy working for the company, with an average 4.0 / 5 rating on Indeed.

Despite their low margins and high competition, pharmacy convenience stores are durable businesses. For instance, FEMSA -- the giant Mexican conglomerate -- suffered massive losses across every business segment *except* its FEMSA Health operation (which *grew* during COVID).

One argument against FRAGUA's model is that nothing stops larger stores (like Walmart) from taking share. While WMT has a heavy presence throughout the country, the two stores serve vastly different purposes. Customers shop at FRAGUA because they need last-minute items or want to get their prescriptions filled. WMT is a planned trip with defined purchase intents.

We see this in Yelp reviews. See John P's example below:

John P. Elite '2021

Burnaby, Canada

211 525 7665

4/27/2014

This Farmacia Guadalajara is a favourite "go-to-place" for us in Puerto Vallarta's south side for a wide-range of pharmacy-related items, general household products, and including deli foods, bakery products, milk, and fruit juices.

We have purchased everything from body and sunscreen lotions in the pharmacy section, to pancake mixes, various fruit juices, milk, deli meats (sliced ham, wieners), various (sliced and unsliced) cheeses (asadero, oxaca, manchego), bakery stuff (sweet buns, rolls, cookies), bolillos ('the' best to be found in Vallarta - crusty, and so good!!), and etc., in other sections of the store.

And so convenient too .. it's open 24/7.

For us, it's a place difficult to walk by on a walkabout, and especially so after dinner in the neighbourhood 'above'. We really enjoy the bakery goods, and much-enjoy taking several (to many!!) back to our hotel for lunches (the bolillos, with a chorizo sausage, a wiener, cheese, ham, and the like) make the best sandwiches!!), evening desserts (pastries with a little coffee liqueur), or pastries as breakfast goodies with coffee the next morning. Yum!

The farmacia offers good selections and prices (and 'on-sale' specials), and it's always open when/if you need something.

Mark B shares similar thoughts:

Mark B.
Portland, OR
207 1156 2818

6/4/2017

1 photo

This is one of my first stops when I'm in Puerto Vallarta. It's big enough I can get the things I didn't want to pack. (I hate checking luggage,. I hated it before they started charging. When I get to my vacation spot I want to start my vacation, not wait for my luggage and the extra long line at immigration...(why is immigration always so much faster anywhere but the USA?)).

They carry everything that a Pharmacy should from prescription stuff to bug spray, a big selection of sun screen and food.

Staff here is never friendly but not are they rude. Really I might have given them 3 or 4 stars but they get an 5 for being always open and always having someone on who speaks English. It's nice to know their there if I need them.

FRAGUA's recipe for success is simple: Great prices, large assortment, fast drug refills, and 24/7 convenience.

Risks, Valuation, and Chart Analysis

The company little (if any) operational risk going forward, and we can't blame them. Twenty-two consecutive years of growing without external financing will give a company that confidence.

Check out this quote from the Annual Report (granted, it's through Google Translate):

> *"The Company does not consider that there are excessive risks in relation to its growth strategy, since it has been carried out with its own resources from its operation and eventually with the support of certain liabilities with cost that do not compromise its financial position."*

There are two scenarios where FRAGUA would need outside financing:

1. Overly aggressive and open too many stores at once
2. Open a fourth Distribution Center without finishing the third one.

FEMSA Health poses another risk to the company's long-term growth goals. While I don't think this is a winner-take-most business, there are certainly NIMBYisms present at the local level. FEMSA has more extensive capital resources from its other business segments and could plow significantly more money into its Health segment if they wished to.

Another risk that one might consider is FX fluctuations. Fortunately, FRAGUA operates only in Mexico and does only does business in pesos.

Valuation

From a pure accounting perspective, the company generated MXN 3.8B in operating income last year. That said, MXN 2B of that came from “other income.” We’re removing “other income” to get a clearer picture of FRAGUA’s core business earnings for the sake of our valuation.

FRAGUA's expecting to grow revenues 6.3% this year and 9% in 2022. There's a good chance the company can sustain high single-digit revenue growth for the next five years. If that happens, we will end 2025 with ~MXN 110B in revenue.

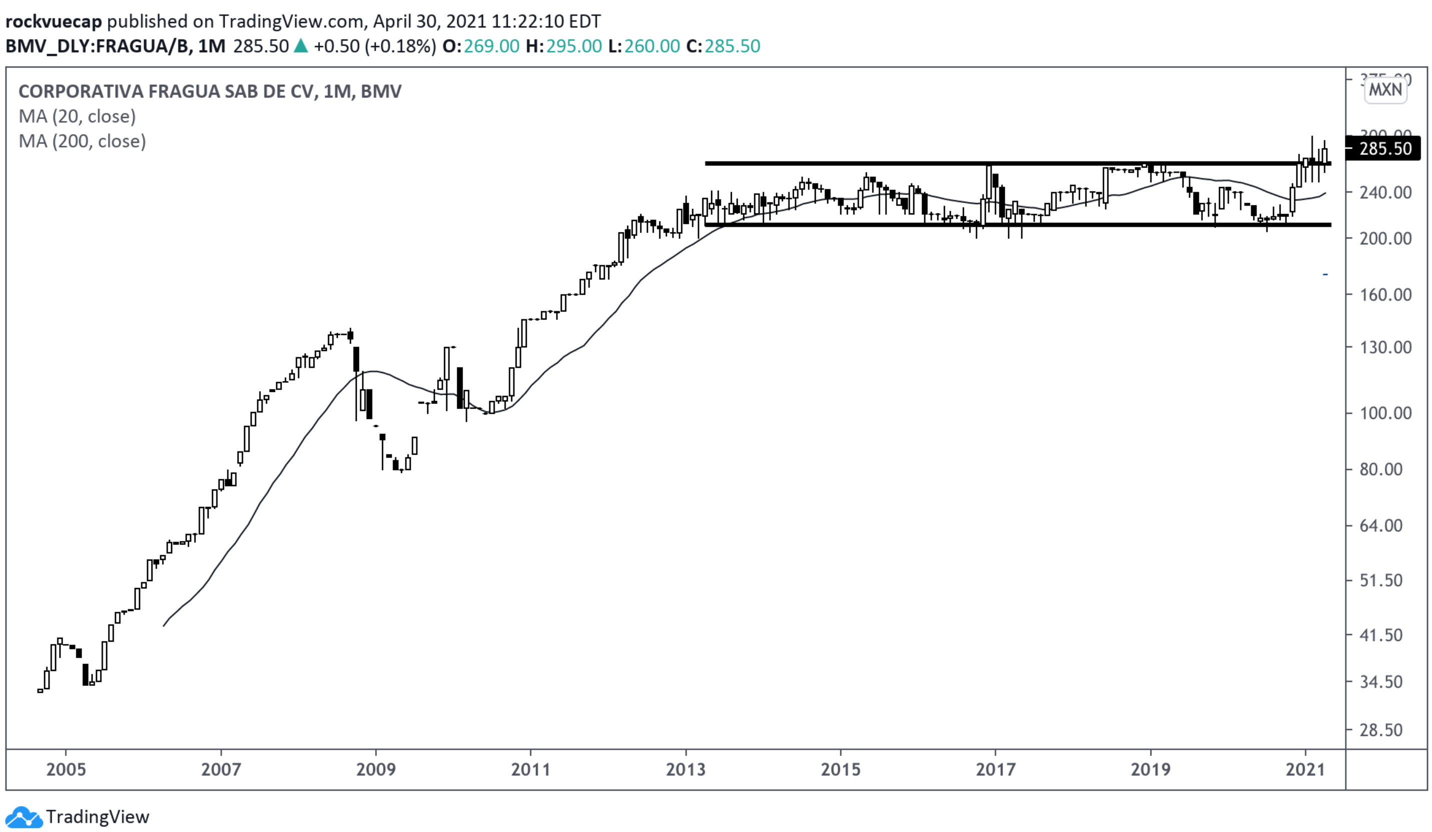
Let's also assume the company maintains its ~2.5% operating margin during that time. In that case, we'd end 2025 with MXN 2.8B in operating income. That's a 10% yield or ~9.6x current Enterprise Value.

FRAGUA also has a history of paying dividends and sports a current 1.2% yield.

Again, all this assumes the company continues to spend on growth CAPEX. **If they pull back that lever, operating income (and margins) should expand, resulting in a potentially higher valuation to a private market buyer.**

Chart Analysis

Finally, the long-term price chart confirms the company's bullish underlying sentiment. The stock is breaking out from an eight-year rectangle consolidation in a Bull Quiet (BQ) regime:



Concluding Thoughts

FRAGUA is a durable business with long-term sociological tailwinds at its back. The company has grown revenues, earnings, and expanded storefronts without outside financing *or* share dilution. With a footprint in 400+ cities and 32+ countries, FRAGUA is well-known throughout most Mexican communities and is a frequent one-stop-shop for consumers' last-minute needs.

The company will continue to expand stores and add a third Distribution Center, further solidifying its position as Mexico's leading pharmacy convenience store. When growth spending slows and the company shifts to maintenance mode, investors will see a business that generates significantly more free cash flow than it does now.

