

# JSE Market Research Competition

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**Sterling**  
Investments Ltd.  
(SIL)

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# Sterling Investments Limited

## Company Overview

**Sterling Investments Limited ("SIL")** is a St. Lucia registered investment vehicle formed in December 2012. The Company focuses on generating interest income by investing in USD fixed income and equity securities and the overall portfolio is managed by Sterling Asset Management, a licensed securities dealer. SIL generates income in two ways: (a) through interest income generated by the securities in the portfolio; (b) through capital gains that are realized as a result of increases in the price of the securities.

**Table 1: Key Features**

<b>Current Price</b>	J\$3.95
<b>Estimated Fair Value</b>	J\$3.47
<b>Implied Downside</b>	<b>-12.25%</b>
<b>52 Week High</b>	J\$5.60
<b>52 Week Low</b>	J\$1.56
<b>YTD% Gain/Loss</b>	<b>9.42%</b>
<b>Current P/E (x)</b>	27.46
<b>Current P/B (x)</b>	1.75
<b>Dividend Yield (T12M)</b>	4.06%

## Where is S.I.L. Heading



Given the increasingly unpredictable nature of the FX rate, SIL's large USD denominated investments is likely to face continued volatility. SIL will likely have to employ a hedging strategy to offset this volatility in earnings by increasing its exposure to other investment opportunities (e.g. private equity and US-denominated real estate transactions). At the same time, the Company could continue to utilize margin facilities to fund its investment activities at a fixed rate in order to lock in a lower interest rate given the current market environment.

Sterling's Investment portfolio is also highly exposed to Global Economic trends. The uncertainties surrounding the US-China trade relations continue to be a downside risk to global economic growth outlook, adding to this are geo-political risks stemming from Brexit. The IMF revised its global growth outlook downwards to 3.5% in 2019. In particular, SIL is exposed to the US economy which is currently entering the 10th year of its bull market run with a more dovish stance of its US Federal Reserve (i.e. low interest rates). The US economy continues to benefit from increased government spending and a tax stimulus package, registering GDP growth of 3.2% in the first quarter of 2019. However, with the likelihood of lower yields in the US instruments, SIL will have to generate higher interest income by reallocating the exposure of its portfolio to emerging market assets. Given

that the hurdle rate is 5.15%, SIL could also seek to boost yield by increasing the risk profile of its investments. The sustained global economic expansion and lower US rates bodes well for higher returns on EM assets. Emerging markets are particularly vulnerable to changes in US interest rates and the dollar's valuation relative to local currencies.

SIL has demonstrated a successful ability to generate returns for its shareholders however remains highly exposed to shifts in the global investment landscape and the shifting domestic FX market. The global investment landscape has shifted and SIL will have to employ a dynamic strategy to boost profitability. This, along with the stock currently trading above its fair value, the recommendation for SIL is a **SELL**

## Macroeconomic & Industry Overview

### Local Economic Trends

Jamaica's investment landscape has transitioned over the last two years as a result the collective efforts of the Government of Jamaica (GOJ). The BOJ has been pursuing an expansionary monetary policy with the primary objective of stimulating economic growth by driving local interest rates lower in order to fuel increased consumption and investment activities.

The GOJ has also been supporting the BOJ's policies through its own initiative to improve the country's fiscal indicators. Inclusive of this is the GOJ's debt management strategy which has been aimed at gradually lowering the country's debt burden and improving the Debt to GDP ratio down to 60% by 2025. Since 2013, under the supervision of the International Monetary Fund (IMF) through the Extended Fund Facility (EFF) and subsequently the Precautionary Stand-By Arrangement (SBA) in 2016, the GOJ has been pursuing a much more prudent

fiscal policy characterized by high primary surpluses and tangible debt reduction.

### What is the impact on the Financial Services Industry?

- The BOJ has changed the mechanism through which it intervenes in the foreign exchange (FX) market through the introduction of the FX auction system, B-FXITT. Consequently, there has been more transparency and coordination in monetary policy efforts in order to curb prior trends in the FX movement. This has resulted in institutions have to rely on additional sources of income outside of historical FX gains.
- A by-product of the combined efforts of the BOJ and the GOJ has been the reduced presence of both entities in the local capital markets. This has resulted in built up demand for local JMD and USD denominated assets

- The reduced funding need of the Government has also reduced the ‘crowding out effect’ which has allowed for more capital to become available to be invested in the private sector.
- The low interest rate environment has impacted the returns of Financial Institutions who primarily generate revenue from interest income in a higher interest rate environment. The local financial services industry has transitioned from focusing on On-Balance sheet offerings such as repurchase agreements to Off-Balance sheet offerings such as Collective investment schemes and generating fee and commission income.
- **The introduction of Expected Loss Impairment Model** – Institutions are required to provide more timely/earlier recognition of expected credit losses.
- **Higher Compliance costs** - Companies are required to have more robust procedures and systems to comply with the new standards.

## New Accounting Standards: IFRS 9 - Financial Instruments

Effective January 1, 2018, accounting standard IFRS 9 replaced International Accounting Standard 39 (IAS 39) which represented a major shift in accounting standards for Financial Institutions in their financial reporting. The key impact of the IFRS 9 includes:

- **Income Statement volatility** – IFRS 9 reclassifies how financial assets and liabilities are accounted for on an on-going basis. Specifically assets being measured at fair value through profit & loss (FVPL) will result in more volatile earnings reported.
- During 2018, there was considerable volatility across all asset classes as we saw a divergence from the traditional stock-bond correlation as the global market observed both equity and fixed income prices moving in similar directions downwards. This was supported by the US Federal Reserve’s tightening stance which resulted in four interest rate hikes in 2018 to 2.5%. In the Corporate bond market, both investment grade and high yield assets saw spreads widening as investors grew increasingly concerned about a slowdown in global growth given uncertainty surround US-China trade tensions and weaker inflation expectations. Emerging Market assets took the largest beating as The J.P. Morgan Emerging Markets Bond index USD index returned -2.46% in 2018.
- However, low interest rates seem likely to remain key developments in the short-term for the United States economy. Although

uncertainty surrounding global trade has remained high, the dovish stance of the US Federal Reserve presents an opportunity for positive performance of other assets classes (e.g. Emerging Market bonds).

- Brexit uncertainties have weighed on global economic growth outlook. The Bank of England's (BoE) key interest rate is currently 0.75% due to the on-going uncertainty

surrounding the United Kingdom's (UK's) departure from the European Union (EU). Given the global trade war uncertainties and the uncertainty surrounding Brexit, it is likely that the rates in the UK will remain low. The downside risks to the UK's economic outlook depend highly on the nature of the deal. With the policy rate being so low they have little room to reduce rates further to stem off any possible recession.

# Financial Analysis

## Income Statement

Sterling Investment’s earnings performance has largely been driven by the growth in Interest Income. The Company has also benefitted from FX gains due to historical depreciation in the JMD against its USD counterpart. This was up until FY 2017 in which the 2.68% revaluation resulting in SIL experiencing a loss of

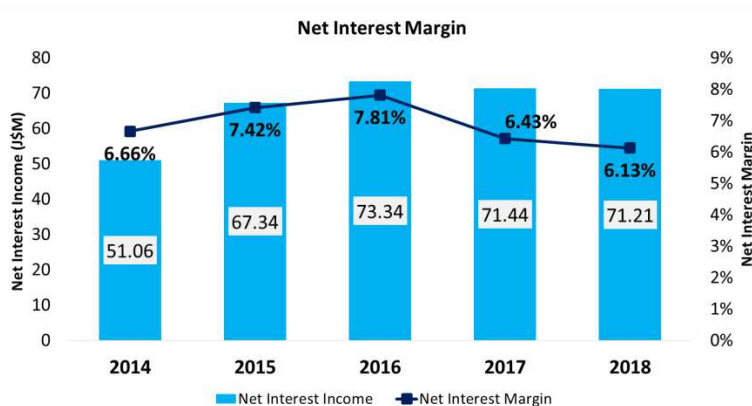
J\$26.24M. This was as a result of the Company net foreign currency position of US\$7.09M as at end-FY 2017. The subsequent 2.17% depreciation of the dollar at the end of FY 2018 supported a J\$23.0M FX gain during the year.

The global bond market experienced volatility across and spreads for corporate bonds have increased considerably. However, SIL experienced a decline in net interest margins, ending FY 2018 at 6.13% relative to the 6.43% in FY 2017.

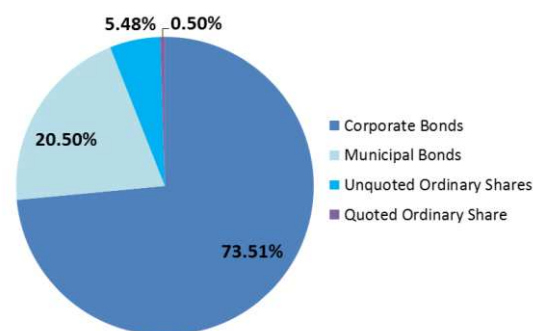
In FY 2018, SIL’s expenses rose by 47.15% year over year due to an increase in interest expenses and impairment losses and unrealized fair value loss on equity investments through the P&L. These losses were due to the re-measurement on securities due to the compliance with IFRS 9. Other Operating Expenses mainly comprises of management fees<sup>1</sup> paid to Sterling Asset Management, the investment manager. As an investment vehicle, the Company operates without employees.

SIL generated Net Profits of J\$53.82M, representing a 4.14%

**Table 2: Net Interest Margin Movement**



**Investment Securities Composition FY 2018**



<sup>1</sup> **Fee Structure** – The Asset Manager receives a management fee of 0.5% of the value of the assets under management each quarter and a Performance Fee of 25% of profits in excess of the hurdle rate are paid to preference shareholders. The hurdle rate is the 10 Year US-Treasury yield plus 300 basis points (Currently at US 10-YR T-Bill rate 2.515% + 300 bps = 5.15%).

or J\$2.14M growth from FY 2017. This performance is still trending below prior year performance due to the slowdown in interest income growth and FX earnings.

## Balance Sheet

As at FY 2018, total assets were J\$1.2B, representing a YoY increase of 3.49% or J\$40.79M. This was driven by a growth in investment securities by J\$50.81M offsetting the decline in Cash balance of J\$11.21M. The increase in investment securities between FY 2014 and FY 2017 was also funded by re-invested and the proceeds of Dividend Re-Investment Programme (DRIP) and Complementary Share Purchase Programme (CSPP) which began in FY 2016. The Investment securities largely comprise of investment grade and high yielding corporate bonds and municipal bonds.

SIL's total liabilities expanded by J\$61.7M or 20.48% YoY to J\$364.35M as at FY 2018 due to a growth in margin loans. The Company has US\$2.64M in margin loans due to overseas brokers bearing interest from 2.75% to 4.30% and are collateralized by securities purchased using the loan. This strategy to maximize returns using leverage saw an increase in the cost of funds from 2.50% - 3.30% in FY 2017 and poses the potential risk of magnifying losses. Total Shareholder Equity's grew at a CAGR of **11.89%** between FY 2014 and FY 2018 due to the steady growth in retained earnings as well as a steady increase in share capital as the Company has undertaken additional share issuances. As at FY 2018, shareholders' equity was J\$845.54M, a YoY decline by 2.42% or J\$20.98M due to a decline in fair value reserve. This amount represents the cumulative net change in the fair value of debt securities measured at fair Value through Other Comprehensive Income (FVOCI).

## Investment Pros & Risks

Positives	Cons
<ul style="list-style-type: none"> <li>• <b>Generous Dividend Policy</b> – The Company doesn't have an established dividend policy, however has a generous dividend pay-out ratio of 40-50% in recent periods.</li> <li>• <b>Growth Strategy</b> – Their investment securities are liquid and marketable securities relative other Brokers with</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Foreign Currency Exposure</b> - The Company maintains its investment assets in foreign currency, mainly USD. The revaluation of JMD is likely to lead to volatility in FX gains and translations.</li> <li>• <b>Concentration Risk</b> – The investment vehicle is substantially invested in fixed income USD assets. As it was initially started as a USD hedge for investors, the Company is highly exposed to a potential downturn in the US.</li> </ul>



- substantial GOJ and local corporate note securities.
- **Market liquidity** –The Company has a market Float of approximately 40%.
- **Diversified Fund** – SIL’s asset allocation spans various regions and asset classes.
- **Margin Loans** – The Company exposure to increasing cost of Funds due to the variable rate cost.
- **Tax benefit** – Currently Investors are able to earn tax free USD dividend income The Company elected to be charged at the rate of 1% as allowed under the International Business Companies Act. However, St. Lucia was recently blacklisted by the European Union as one of the countries reportedly not adhering to tax good governance. St. Lucia is currently undergoing a tax reform plan to meet international standards.

## Key Risk Assessment

Type of Risk	
<b>Country Risk</b>	The Company’s portfolio of assets is highly exposed to North America (40%) and Europe (32%).
<b>Credit Risk</b>	The Company considers a debt investment security to have low credit risk when its credit risk rating is equivalent to the globally understood definition of ‘investment grade’. SIL’s portfolio of assets is <b>67.3%</b> exposed to investment grade securities which are considered “lower risk”.
<b>Currency Risk</b>	At the end of December 2018, SIL had a long FX position of US\$6.7M and as shown in its financial performance, benefits from a depreciation of the Jamaican dollar. However given the volatility in the FX market, we will continue to see fluctuations in income from FX movements,
<b>Interest Rate Risk</b>	SIL faces risks to its interest income within the context of decreasing interest rates in the domestic and international market. Based on SIL’s interest rate Gap sensitivity, its financial liabilities (the Margin loan) are more sensitive to interest rates given its variable rate feature.
<b>Governance Risk</b>	SIL’s displays adequate corporate governance. Of the four non-executive Directors serving during the year, 75% of them were deemed to be independent and show a diversity of expertise.

# Valuation Models

## Stock Overview

Due to SIL being an USD investment vehicle, there was no direct comparable in its industry. The stock is fairly liquid with a fair amount of volume traded. With a beta of 1.35, the company displays more volatility than the market.

**Table: 3:** Stock 1-Year Price Movement



December	2014	2015	2016	2017	2018
<b>MARKET VALUATION</b>					
<b>Book Value Per Share</b>	J\$1.76	J\$2.26	J\$2.64	J\$2.82	J\$2.75
<b>Dividends Per Share</b>	J\$0.03	J\$0.06	J\$0.06	J\$0.10	J\$0.07
<b>Earnings Per Share</b>	J\$0.19	J\$0.23	J\$0.26	J\$0.17	J\$0.18
<b>Dividend Payout Ratio</b>	16.20%	24.62%	24.59%	58.93%	40.28%

## Valuation Assumptions & Forecasts

SIL's fair value was determined using a combination of a Price to Book (P/B) model and a Price to Earnings (P/E) model to derive a fair value of J\$3.47. This would imply SIL is overvalued and has an implied downside of **12.25%** relative to its current price of **J\$3.95** as at April 18, 2019. Following Sterling's Right's Issue in which it rose J\$600M, it was assumed these funds would be immediately deployed into interest earning assets. Additionally it was assumed SIL would experience volatility in Foreign exchange earnings as result of its Net USD FX position being maintained. Sterling is projected to earn approximately **J\$73.98M** (EPS: **J\$0.20**) in FY 2019 ending December 2019.

**J\$3.47**  
Fair Value

P/E Valuation	J\$2.97
P/B Valuation	J\$3.97
<b>Fair Value</b>	<b>J\$3.47</b>

## Market-Based Models

Using an average SIL's 5-Year Historical Average P/E multiple of **15.00x**, an estimated fair value of **J\$2.97** was derived. Using an estimated 5-year P/B multiple of **1.05x**, an estimated fair value of **J\$3.97** was derived.

The valuation multiples (P/E & P/B) are contingent to the performance of the market. Therefore, the valuation is susceptible to shifts in macroeconomic variables.

# Appendix

## Appendix 1: Financial Statement Extracts & Financial Ratios

### INCOME STATEMENT (EXTRACT)

J\$ ('000)						
December	2014	2015	2016	2017	2018	Proj- 2019
<b>Revenue</b>	<b>96,704,385</b>	<b>119,290,357</b>	<b>141,433,774</b>	<b>90,657,900</b>	<b>110,445,919</b>	<b>161,508,587</b>
Interest Income	55,016,387	72,778,939	78,099,467	79,081,255	82,200,785	113,781,887
<b>Expenses</b>	<b>(28,494,925)</b>	<b>(36,960,617)</b>	<b>(49,388,171)</b>	<b>(36,273,637)</b>	<b>(53,377,072)</b>	<b>(46,876,442)</b>
Interest Expense	(3,953,304)	(5,442,115)	(4,759,702)	(7,642,960)	(10,993,501)	(15,170,918)
<b>Operating Profit</b>	<b>68,209,460</b>	<b>82,329,740</b>	<b>92,045,603</b>	<b>54,384,263</b>	<b>57,068,847</b>	<b>114,632,145</b>
<b>Profit for the year</b>	<b>58,630,699</b>	<b>71,168,007</b>	<b>78,597,393</b>	<b>51,677,219</b>	<b>53,819,008</b>	<b>73,984,824</b>
EPS	0.19	0.23	0.26	0.17	0.18	0.20
<b>Outstanding Shares</b>	<b>4,014,547</b>	<b>55,876,281</b>	<b>56,101,917</b>	<b>58,834,167</b>	<b>307,131,640</b>	<b>374,094,682</b>

### BALANCE SHEET (EXTRACT)

December	2014	2015	2016	2017	2018	Proj- 2019
Investment securities	766,737,135	907,825,257	938,603,156	1,110,936,549	1,161,747,542	1,993,305,438
<b>Total Assets</b>	<b>787,044,030</b>	<b>935,770,085</b>	<b>974,701,408</b>	<b>1,168,095,124</b>	<b>1,208,889,427</b>	<b>2,036,305,438</b>
Margin loans payable	223,886,387	214,341,641	131,808,102	274,814,733	336,229,212	378,428,940
<b>Total Liabilities</b>	<b>247,550,919</b>	<b>241,881,459</b>	<b>164,274,804</b>	<b>301,575,830</b>	<b>363,349,591</b>	<b>410,936,490</b>
<b>Total Equity</b>	<b>539,493,111</b>	<b>693,888,626</b>	<b>810,426,604</b>	<b>866,519,294</b>	<b>845,539,836</b>	<b>1,488,811,496</b>
<b>TOTAL DEBT</b>	<b>247,550,919</b>	<b>241,881,459</b>	<b>164,274,804</b>	<b>301,575,830</b>	<b>363,349,591</b>	<b>410,936,490</b>

### KEY FINANCIAL STATISTICS

December	2014	2015	2016	2017	2018	Proj- 2019
<b>PROFITABILITY</b>						
Return on Equity	10.87%	10.62%	10.24%	5.65%	9.78%	4.97%
Return on Assets	7.45%	8.26%	8.23%	4.82%	4.53%	4.56%
Operating Margin	73.54%	72.32%	67.35%	65.51%	57.38%	78.33%
Profit Margin	63.21%	62.51%	57.51%	62.25%	54.12%	50.56%
Net Interest Margin	6.66%	7.42%	7.81%	6.43%	6.13%	4.95%
<b>EFFICIENCY</b>						
Asset Turnover Ratio (x)	0.12	0.12	0.14	0.07	0.08	0.07
<b>LEVERAGE</b>						
Leverage Ratio (x)	1.46	1.40	1.27	1.28	1.39	1.39
Total Debt/Total Equity (x)	0.46	0.35	0.20	0.35	0.43	0.28
Total Debt/Total Assets (x)	0.31	0.26	0.17	0.26	0.30	0.20

**Appendix 2: Top 10 Shareholders - SIL**

**Shareholders for Sterling Investments Limited as at December 2018**

<b>Name of Shareholder</b>	<b>Share Capital</b>	<b>Percentage Ownership</b>
ATL Group Pension Fund Trustees	48,315,893	15.73%
Lloyd Badal	26,664,616	8.68%
GraceKennedy Limited Pension Scheme	26,136,350	8.51%
Pam- Pooled Equity Fund	22,025,175	7.17%
Pam- Cable & Wireless Real Estate Fund	14,492,015	4.72%
Satyanarayana Parvataneni	10,601,480	3.45%
National Insurance Fund	10,080,645	3.28%
Charles A. Ross	10,047,515	3.27%
Winnifred M. Mullings	8,292,420	2.70%
Everton Lloyd Mcdonald	7,998,950	2.60%
<b>TOTAL</b>	<b>184,655,059</b>	<b>60.12%</b>