Company Analysis: Sterling Investments Limited (SIL)

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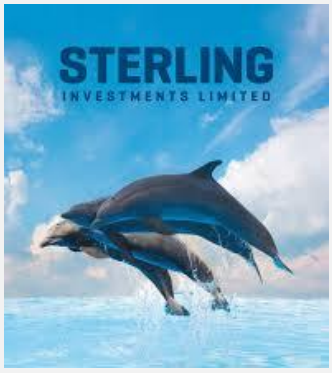


- Recommendation: **MARKETWEIGHT**
- Price Target: JMD 3.82/ USD 0.024
- Current Price: JMD 3.60/ USD 0.020[1]

- Shares Outstanding: 377,028,367 units
- Market Value of Shares Outstanding: $1.357 billion[1]
- Financial Year End: December 31

ABOUT THE COMPANY

Sterling Investments Limited (SIL) is an investment holding company that was formed in 2012. The company exists to protect and grow the capital of its shareholders by investing in bonds and equities. SIL listed its ordinary shares on the Main Market of the Jamaica Stock Exchange in October 2014. The company invests primarily in an array of high-quality fixed income securities denominated in United States dollars. A small part of the company's portfolio is also dedicated to private equity investments that serve to boost the company's return on equity.

FINANCIAL PERFORMANCE

	2017	2018	2019
Net Income ($M)	90.66	110.45	148.37
Total Assets ($B)	1.17	1.21	1.63
EPS ($)	0.67	0.64	0.28
ROE (%)	6.2	6.3	6.8
P/E (x)	14.61	5.64	11.92
Dividend Per Share ($)	0.53	0.45	0.09

Outlook

SIL may be one of the first to benefit from the economic recovery post pandemic due to its exposure to assets in mainly developed countries. We expect the company's performance to remain stable as it is exposed to mainly investment grade assets, which have a fairly low default rate. We anticipate that the company will continue to increase its investment portfolio, increasing returns to shareholders and it may also include more higher yielding bonds to improve its net interest margin. We expect, through stability in its income, the company will also maintain its dividend policy.

Projections and Valuations

Using the average of a P/E multiple of 12x, P/B multiple of 1x applied to the 2021 forecasts, and a Residual Income Method with a required rate of return of 8%, we arrive at an average target price of **$3.82**.

Risks to Price Target

SIL faces risk associated with general market movement. If prices in the market increase quickly then SIL may generate gain on the sale of some of its instruments. On the other hand, if the market was to experience another downturn, or if their portfolio was to see material defaults, company's equity would be negatively impacted by losses on these instruments.

1 November 30,2020

FINANCIAL PERFORMANCE

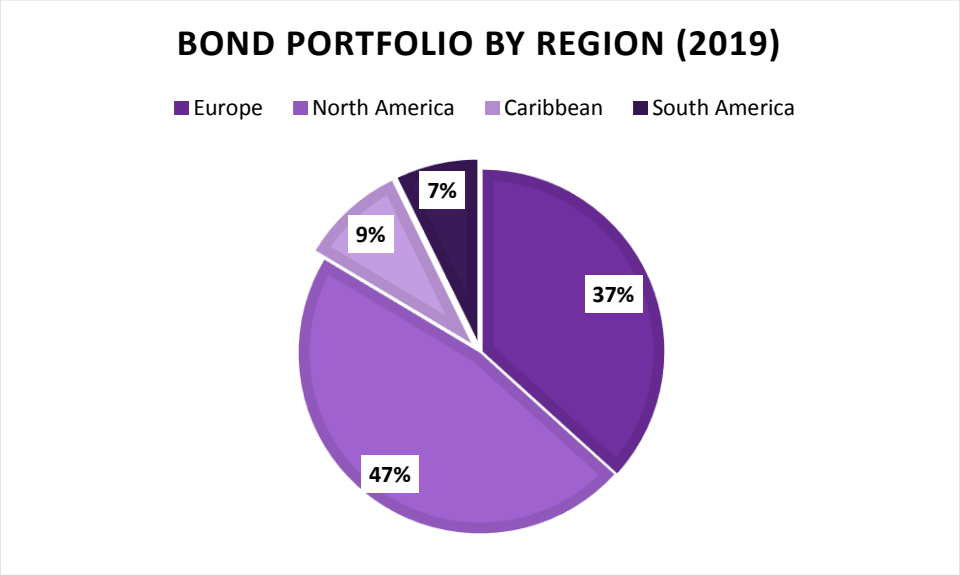
($'000)	2017	2018	2019	2019 Q3	2020 Q3
Total Revenue	90,658	110,446	148,373	140,940	170,309
Net Profit	51,677	53,819	101,166	100,209	94,389
Total Assets	1,168,095	1,208,889	1,633,999	1,586,057	1,698,744
Total Liabilities	301,576	363,350	405,354	369,982	486,197
Total Equity	866,519	845,540	1,228,645	1,216,075	1,212,548
Net Interest Margin (%)	7.0	6.3	6.2	5.4[2]	6.7[2]
Return on Equity (%)	6.2	6.3	9.8	11.0[2]	10.4[2]

[2] Annualized figures

FOR THE LAST THREE (3) YEARS:

Sterling Investments Limited (SIL) has performed well in the last 3 years with profit nearly doubling during the period. Net Profit increased from $51.7 million in 2017 to $53.8 in 2018 and then further to $102 million in 2019. This increase is primarily the result of consistent increases in Interest Income (average growth of 11.8%) on the back of the expansion in its investment portfolio, along with increases in Foreign Exchange Gains driven by the depreciation of the Jamaican Dollar against its US counterpart. Interest Income increased from $79.1 million to $98.3 million, though the Net Interest Margin has declined from 7.0% to 6.2%. This decline is primarily as a result of the decline in the yield generated from the company's bond portfolio. The company has also benefited from gains on its bond and equity trading portfolio. Total Operating Expenses have fluctuated during the period due to volatility in Unrealized Fair Value Losses on its Investment Securities. Interest Expense and Other Operating Expenses, on the other hand, have gradually increased. Interest Expense increased from $11.0 million in 2017 to $14.0 million in 2019, as the company has taken on more margin loans to partially fund the increase in its investment portfolio, and Other Operating Expenses have increased by an average rate of 16.2%. Interest Expense on SIL's preference shares have also increased significantly, from $1.9 million to $7.2 million, as the performance of investment portfolio as managed by the investment managers, Sterling Asset Management Limited (SAML), has outperformed the benchmark and thus contributed to increases in the management fees. Nonetheless, profitability as measured by the Net Profit Margin and Return on Equity has increased from 57.0% to 68.2% and from 6.2% to 9.0%, respectively.

SIL's balance sheet has increased 39.9% over the 3 years driven by the increase in Investment Securities of 42.9%. This was funded by both an increase in Liabilities and Equity. Total Liabilities increased by 34.4%, due to the 27.7% increase in Margin Loans and the more than doubling of Related Company liabilities. The increase in Related Company (SAML) liabilities was as a result of unpaid management fees. Shareholders' Equity increased 41.8% due to an increase in share capital, the fair value reserve and retained earnings. At the end of 2018, after a 5 for 1 stock split, the company conducted a rights issue where it offered shareholders 2 new shares for every 3 shares owned. The company issued over 66 million new shares and raised $202.4 million. Overall, the Fair Value Reserve increased in 2019 to $53.0 million from -$30.5 million due to the increase in asset prices in 2019. Retained Earnings also increased 19.9% as a result of the company's continued profitability offset by dividends paid. SIL has consistently paid dividends bi-annual and its payout ratio has average 51.1% during the period.



FOR THE FIRST NINE (9) MONTHS OF 2020:

SIL continued to thrive in the third quarter despite the ongoing effects of COVID-19 on the local economy. The company's Net Interest Income increased by 30.8% year-on-year due to a combination of lower Interest Expense and continued growth in the size of its investment portfolio. Net Interest income totaled $80.6 million for the nine-month period, 30.8% higher than the $61.6 million recorded for the corresponding period in 2019. The Net Interest Margin also increased from 5.4% to 6.7%. SIL also reported higher Unrealized Foreign Exchange Gains while contributed to the increase in Total Revenue to $170.3 million, a 20.8% increase when compared to $140.9 million for the same period of the previous year. However, Net Income decreased by 5.8% from $100.2 million to $94.39 million due to an increase in Expenses for the period, primarily Unrealized Held for Trading Revaluation Losses which totaled $21.7 million, compared to a gain of $8.8 million in 2019. Other Operating Expenses did decline 3.2% for the nine-month period from $28.9 million $27.9 million.

Total assets increased by 7.1% from $1.6 billion to $1.7 billion, primarily due to an increase in Investment Securities from $1.5 billion to $1.7 billion. Total Equity, on the other hand, decreased by 0.29% from $1.22 billion to $1.21 billion as a result of a reduction in the fair value reserve due a brief market sell-off in the global credit markets that occurred at the end of September. Liabilities increased by 21.4% primarily driven by an increase in Margin Loans from $326.1 million to $450.7 million which was used to fund the increase in the company's investment portfolio. Margin Loans now fund 27.02% of the total portfolio of investment securities compared to 21.26% last year.

OUTLOOK:

International Credit Market Outlook and the Impact on SIL's Investment Portfolio

SIL's investment portfolio is largely concentrated in North America (46.8%) and Europe (36.7%) and thus is performance will be dependent on the strength of the economy in both regions and by extension the companies operating there. On the onset of COVID-19, investors restructured their portfolios towards safer asset classes like US Treasuries and out of riskier asset classes like equities and corporate bonds, pushing prices downwards, as they practiced an abundance of caution given the uncertainty surrounding the pandemic. Many investors at this point were expecting many corporate defaults due to the slowing in the global economy cause by the virus. Nonetheless, the sell-off provided an opportunity for other investors to pick up bonds trading at attractive yields. Since then, prices have begun to recover though they are still not at pre-COVID levels. Investment grade spreads are still higher than pre-COVID levels implying that there is still some recovery left for the markets. This may provide SIL's management the ability to pick up some still undervalued bonds that are trading at attractive yields to not only benefit from the interest payments but also further capital appreciation.

Heightened Risk of Defaults across Bond Ratings

Most industries have been negatively affected by the pandemic. The slowdown in the economies worldwide have resulted in a reduction of cash flow for many companies, especially as some may have had to close due to shutdowns in their respective regions. As of September 2020, 470 companies have filed for bankruptcy, more than the number of filings during any comparable period since 2010, with more than 90% being speculative grade bonds. S&P Global Ratings forecasts a K-shaped recovery with larger more financially stable companies rebounding well post-pandemic and having positive outlooks, while those that had a weaker balance sheet face the risk of defaulting. Since the majority of SIL's portfolio contains investment grade bonds (90.9%), the portfolio is likely to remain strong and perform well in the short term. As the brunt of the pandemic passes, SIL may look for higher yielding bonds that are expected to generate strong free cash flows and have a healthy balance sheet, in order to ascertain a higher yield on its portfolio.

Declining Interest Margin and Profitability

SIL's Net Interest Margin has been declining fairly consistently since 2015 from 8.2% to 6.0%, in line with the overall decline in interest rates. The Benchmark Interest Rate in both the US and Europe have declined to all time lows of 0% - 0.25% and 0% respectively. The US Federal Reserve has stated that it will not raise interest rates until it believes that the American economy has recovered from the pandemic, implying that it does not foresee any interest rate hikes till 2021. As such, we do not expect that coupon rates will increase until at least 2021, keeping the interest margin low.

Dividends Should Remain Stable with a High Payout Ratio
SIL has consistently paid dividends to its shareholders biannually, with a general upward trend. We expect that the company will maintain this trend providing shareholders with consistent USD earnings, providing a hedge against the depreciation of the Jamaican dollar.

Low Debt to Equity Ratio Allows for Greater Room to Build Investment Portfolio
SIL maintains a fairly low debt-to-equity ratio which has averaged 33.2% over the last 5 years. With a low debt to equity, the company has the capacity to take on more debt to bolster its investment portfolio and provide greater returns to its shareholders. SIL will also benefit from the low interest rate environment as it borrows to build its portfolio.

INVESTMENTS POSITIVES:

- Low Leverage
- Dividends are earned in US Dollars which hedges against the depreciation of the Jamaican Dollar and inflation
- Registered in St. Lucia which provides tax benefits
- High Profitability

INVESTMENT NEGATIVES

- Exposed to the volatility of the foreign exchange rate
- Portfolio consists mainly of Interest Income, which is dependent on interest rate return

CONCLUSION

Despite the adverse effects that the COVID-19 pandemic has had on asset prices, both globally and locally, SIL's strategy has been robust throughout the crisis. Lower interest rates are likely to increase the value of SIL's assets and reduce the cost of liabilities over time. Shareholders of SIL are benefiting from the company's high exposure to high quality bonds as over 90% of SIL's bond portfolio is investment grade. As it is likely that developed countries will lead the global economic recovery, SIL may be among the first locally listed companies to benefit from a global economic recovery as its exposure to developed countries is substantially high.

The company still faces the risk of market fluctuations on the value of its portfolio and the risk of its portfolio companies defaulting, depending on that company's operating environment. However, given the quality of the bonds in its portfolio, we expect the risk of default to be low.

Using the average of a P/E multiple of 12x, P/B multiple of 1x and a Residual Income Method with a required rate of return of 8%, we arrive at an average target price of $3.82. This price represents a 6.1% price appreciation from current levels, and investors would earn a yield of approximately 9%. Therefore, we recommend that investors **MARKETWEIGHT** this stock.

SOURCES

The Jamaica Stock Exchange, SIL Annual Reports and Quarterly Financials, S&P Global Ratings

DISCLAIMER

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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.