VM Wealth Management Limited

Company Analysis: Sygnus Credit Investments Limited (SCI) FY 2022/23

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SYGNUS CREDIT INVESTMENTS

- Stock Recommendation: **OVERWEIGHT**
- Current Price: J$11.18/ US$0.09
- Price Target J$19.42/ US$0.12

- Shares Outstanding: 345,761,426 units
- Financial Year End: June 30

ABOUT THE COMPANY

Sygnus Credit Investments Limited (SCI) was incorporated January 2017 in the island of St. Lucia and is an International Business governed by the International Business Companies Act 1999. The company, which listed on the Main Market of the JSE in 2028, specializes in investing in private credit instruments and other structured instruments and has targeted small to medium enterprises to assist with growth and expansion via non-traditional financing. Sygnus Capital Management Limited and Sygnus Capital Limited are the two branches under the parent company (Sygnus Capital Group Ltd), with Sygnus Capital Management Limited (Cayman) being the Investment Manager for the Sygnus Credit Investments Limited.

SCI completed the acquisition of a 93.7% stake in Acrecent Financial Corporation ("AFC") through its subsidiary SCI Puerto Rico Inc ("SCI PR Inc.") on February 28, 2022. This investment in Puerto Rico gives SCI access to a Spanish-speaking private credit market in a US$100.7 billion US territory within the Caribbean region, exposure to industries not accessible in the English-speaking Caribbean and exposure to a fundamentally stronger set of portfolio companies.

SCI recently commenced its 3-year share buy-back programmed, aimed at bolstering the stock price and add more liquidity. As of July 4, 2023, 2,614,799 units of shares repurchased, funded through cashflow and debt.

FINANCIAL PERFOMANCE SUMMARY

US$	FY 2019/2020	FY 2020/21	FY 2021/22	FY 2022/23
Net Interest Income	4,492,018	6,424,202	7,104,753	8,135,336
Total Income	4,573,658	6,486,988	11,124,812	9,773,381
Net Profit	1,972,793	5,028,317	3,823,104	5,134,638
Total Assets	61,039,613	87,870,447	136,793,967	163,864,434
Total Liabilities	23,367,254	21,134,371	69,331,498	94,057,381
Total Equity	37,672,359	66,736,076	67,462,469	69,807,053

Dividend Policy

Sygnus Credit Investments Limited's Dividend Policy stated that the firm will make dividend payments of up to 85% of SCI Net Income on a quarterly basis after making adequate provisions for its reserves. SCI has consistently made dividend payments over the last five years, with an average payout ratio of 59.26%. In the last financial year SCI paid out US$2.45 million to shareholders.

Outlook

Geopolitical occurrences like trade disputes, conflicts, or health crises, such as the COVID-19 pandemic, can bring about unpredictability and have adverse effects on the credit investment industry. Nevertheless, SCI has demonstrated its ability to withstand the challenges posed by the COVID-19 pandemic by enhancing its financial performance and consistently distributing dividends. However, the ascent of interest rates can influence the value and effectiveness of credit investments, particularly fixed-income securities. Despite the occurrence of other less favourable economic circumstances, SCI's growth strategy is anticipated to have a favorable impact on the company's overall performance.

Projections and Valuation

A market comparable approach was used to obtain a fair value of SCI, using a 2024 forward BVPS and EPS of US$0.12 and US$0.01, respectively. Given the company's historical financial performance and the recent acquisition, an applied P/B and P/E of 1.45x and 8.50x were deemed appropriate and were used to determine a relative value. By averaging both prices and using a conversion rate of J$160:US$1, we obtained a consensus target price of US$0.12/JA$19.42, which represents a substantial upside of 73.69% relative to its current price.

Risks to Price Target

The J$ price target could face fluctuations due to exchange rate volatility, but it may tend to lean towards an upward trajectory. This inclination is based on historical patterns, as the J$ has typically experienced an average annual depreciation of 5% against the US$. Additionally, being a credit-focused investment entity, SCI is susceptible to default risk, which could arise from portfolio companies affected by the ongoing repercussions of the pandemic and the prevailing high-interest-rate and inflationary conditions.

FINANCIAL YEAR END JUNE 30, 2023

At the end of the financial year (FY) 2022/2023 SCI experienced a 43.00% or US$3.80 million increase in interest income, as the company expanded its private credit portfolio and began seeing returns from the 93.7% acquisition of Acrecent Financial Corporation (AFC) in Puerto Rico in 2022. However, as monetary conditions remained tight, the 91.15% uptick in interest expense tempered the growth of net interest income (NII). NII grew 14.51% or by US$1.03 million to end the FY at US$8.14 million. Ultimately, total revenue dipped 12.15%, due to a 71.05% decline in Fair value gains from financial instruments at FVTPL, as bond prices continued to fall, and the equities market remained choppy.

Management fees, which jumped 21.98%, was the major contributor to total expenses, but net foreign exchange gains and the decline in Impairment allowance on financial assets fuelled the 37.51% decline in total expenses. Despite the US$2.70 million fall in total expenses, which highlights the company's efforts to contain costs, the core operating efficiency ratio exceeded the 40% threshold. The efficiency ratio deteriorated year-over-year, shedding 670 bps to end at 42.80%. As total expenses declined faster than total revenue, SCI's operating profit jumped 34.48% to US$5.27 million. While the company's taxation expenses had a 41.33% surge to US$136.20 thousand, the taxation margin only had a 12 bps increase to 2.58%. Ultimately, net profit for the reporting period increased 34.31% to US$5.13 million and EPS increased from US 0.65c to US 0.87c, also supported by the share buyback programme.

SCI recorded US$163.86 million in Total Assets, up 19.79% over the figure recorded twelve months ago. A further breakdown in total assets shows that it was mainly comprised of US$151.21 million in private credit investments including investments in preference shares, private credit fund and short-term and medium-term notes, which was also the main driver of the US$27.07 million growth in assets. Notably, the company's net interest margin (NIM) declined from 5.49% to 5.23%, mainly driven by an almost 50% decline in cash balances, which tempered the growth in NII. Total shareholders' equity was US$69.81 million (B.V.P.S.:US$ 0.1186) at the end of the period, versus US$67.46 million (B.V.P.S.: US$0.1142) last year. The company's total liabilities also increased during the reporting period, jumping 35.66% to US$94.06 million. This increase stemmed primarily from the rise in notes payable, which consist of secured, unsecured and senior unsecured notes.

The rise in Notes Payable, Preference shares and Loans and borrowings resulted in SCI's debt to equity ratio gaining 33 bps to end the FY at 1.29x, which is above management's target threshold of 1.25x but below the limit of 2x. Likewise, an additional 8 bps were added to the debt to total assets, which came in at 0.55x and exceeded the 0.50x threshold level. These two ratios were reflective of an increase in leverage, which may stand as a warning for global best practices for private credit companies.

OUTLOOK

Growth in Private Credit and Alternative Investments

The company has established a unique position in both domestic and regional financial markets by addressing a crucial gap necessary for sustainable economic development. This gap revolves around providing private credit options, such as bilateral notes, bonds, preference shares, asset-backed debt, mezzanine debt, and convertible debt, to medium-sized entities in various industries while introducing alternative investment opportunities. The company has set a target of achieving $1 billion in private credit transactions in the short to medium term, with the expectation that this will further enhance interest income. Although SCI will need to take on additional debt to fulfill this goal, the positive credit ratings from CariCRIS, coupled with Jamaica's upgraded credit ratings, are likely to create favorable conditions for debt raising, ultimately leading to the growth of Net Interest Income (NII) and, in turn, boosting the company's profitability.

INVESTMENT POSITIVES

- Geographic diversification across the Caribbean region in Jamaica, St Lucia and Puerto Rico, mitigates economic, political and social risks by spreading investments or operations across various regions.
- SCI makes consistent bi-annual dividend payments, which increases the return on investments to existing and new shareholders.
- SCI aims to expand the private credit portfolio by achieving US$1 billion in transactions throughout the Caribbean region in the short to medium term, which should increase profitability through the anticipated growth in NII. This should bring higher returns to investors, as the P/E ratio, which is currently below the sector's average, is anticipated to increase.
- CariCRIS confirmed SCI's credit ratings as jmBBB+ with a stable outlook and cariBBB- with a stable outlook. This is anticipated to improve borrowing conditions for SCI, which should temper the growth in interest expenses and increase profitability and EPS through higher NII.
- Continued cost containment measures are anticipated to keep the efficiency ratio within the 40% threshold, boost operating income and subsequently the company's net profit.
- The 3-year share buyback programme is aimed at improving liquidity and increasing the value of each stock held by investors.

INVESTMENT NEGATIVES

- With the ongoing geopolitical tensions across the world creating doubt among investors, an economic downturn can decrease the performance of loans and credit instruments, leading to financial losses.
- The current high interest rate environment can reduce SCI's profitability, as rising interest rates can lead to lower bond prices and reduced income from interest-bearing investments assets.
- SCI is exposed to default risks by borrowers, which can lead to losses for the company, a decline in EPS and a halt in dividend payments.

CONCLUSION

SCI has effectively constructed a strong investment portfolio, supplying the essential credit for the growth of its underlying portfolio companies and simultaneously generating interest income. In the present operational environment, SCI encounters heightened credit-related risks as its portfolio companies confront disruptions associated with increasing interest rates and geopolitical tensions. Nevertheless, we anticipate that the company will maintain its resilience, thanks to the expertise of its investment managers, the solid risk management approach it has put in place, cost containment initiatives, regional acquisitions, and an expansion of the private credit portfolio. Additionally, SCI may secure extra income by participating in the profits of these companies through its structures.

We anticipate that the company will further grow its investment portfolio throughout the Caribbean region over the next few years, while maintaining healthy solvency and leverage ratios. A market comparable approach was used to obtain a fair value of SCI, using a 2024 forward BVPS and EPS of US$0.12 and US$0.01, respectively. Given the company's historical financial performance and the recent acquisition, an applied P/B and P/E of 1.45x and 8.50x were deemed appropriate and were used to determine a relative value. By averaging both prices and using a conversion rate of J$160:US$1, we obtained a consensus target price of US$0.12/JA$19.42, which represents a substantial upside of 73.69% relative to its current price. Therefore, we recommend that investors **OVERWEIGHT** the stock in their portfolios.

SOURCES

Bloomberg, PSOJ, SCI's Website, IMF, SCI's Financial Statements, JSE, Loop News Jamaica, Jamaica Observer, Jamaica Gleaner

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.