Mine Investment opportunities in the Sri Lankan Equity Market

Introduction

The post war Sri Lankan economic prosperity encourages investors to seek investment opportunities which were previously overlooked. The turnover of the Colombo Stock Exchange (CSE) rose by 25% and All Share Price Index moved to 6% when compared to severe drop of 40% in 2008[1]. These key figures imply emerging upward trend in stock market transactions. Ordinary shares are one of the most famous securities trading in CSE. Hemas Power Ltd announced Initial Public Offering where 31,300,000 ordinary shares issued at Rs.17-Rs.20 to the public for the first time[2] while Seylan Bank PLC announced 54,290,000 ordinary shares at Rs. 35/- per share on offer to the general public recently.[3]. Ordinary shares of a company are often called equity or common stock. Have you ever thought of buying shares in listed companies as an attractive investment avenue?

Making a decision to buy ordinary shares in companies listed in the Colombo Stock Exchange needs to be the ultimate decision after a series of careful screening and thorough analysis of information available to any individual who is keen on such an investment, even though registered stock brokers assist in the process. Keeping a weather eye on the changes in business environment, general understanding of information provided by the Colombo Stock Exchange (CSE) and various other sources such as company's prospectus, annual report, interim financial statements, public announcements, press releases, and discussions will enable to become a successful player in stock market. In addition to that the stock market could be used as a breeding ground for your investments. The scope of this article is to give an insight into preliminary information gathered for a beginner to equity investments.

Benefits of Investment in Ordinary Shares

The individuals who invested on ordinary shares of a company become owners of that company, become eligible to get annual and interim dividend payments announced by the company, and can have a steady cash flow in intervals. Dividends can be in the form of shares instead of cash, often called scrip dividends or bonus issues and they can obtain a capital gain by selling shares in the stock market if share price moves above the purchased price at the selling point. In addition to that they get an opportunity to expand their investment by purchasing shares from rights issues announced by the company since priority will be given to existing shareholders. Further, they may gain additional shares from share splits where the company may distribute additional shares to prevent the increase in the share price intolerably high and to keep it more transferable. If the shareholder buys ordinary shares with voting rights he will be able to participate in annual general meetings and actively contribute in the decision making process.[4]

Downsides of the Investment

Investor has to keep in mind about the underpinning risk of investing in ordinary shares. With sudden corporate collapses there's a chance of losing the entire investment. For example, one of the biggest ever financial scandals in the Sri Lankan history was, the collapse of the Pramuka Bank PLC, which led to thousands of investors being helpless. The supervisory arms of the Central Bank of Sri Lanka, the Department of Inland Revenue, and

1 Postwar Sri Lanka Holds Promise, at Last By Ellis, E 02.08.2009 http://www.srilankaequity.com/2009/08/postwar-sri-lanka- holds-promise-at-last.html
2 Hemas Power Ltd Prospectus issued 31.08.2009
3 Daily Mirror Financial times 22.09.2009 http://www.dailymirror.lk/DM_BLOG/Sections/frmNewsDetailView.aspx?ARTID=62207
4 Companies Act No 7 of 2007 Sec 53, Sec 60 and Sec 529, http://www.sec.gov.lk/ lastly retrieved on 09.09.2009

Securities and Exchange Commission of Sri Lanka took legal actions and other remedial measures to safeguard the wealth of investors[5]. Securities Exchange Commission maintains the rules and regulations by strictly monitoring the companies listed in CSE. Suspicious companies which are unable to meet the obligations are being displayed in the default board. Further, external environmental changes (i.e. business cycle, war and civil unrest, political changes etc.) can affect short term windfall profits as a result of share price fluctuations. If the company fails to outperform in operational activities and is unable to make profits to pay dividends, the equity investor has to forego the return. There is a fine line between making a profit out of investing in ordinary shares and losing the entire investment.

Considerations Before entering into the Equity Market

Which shares need to be bought from which company will depend on various personal preferences such as the individual's willingness to accept risk and his capacity to absorb the market volatility, investor's future expectations about the investment, company, industry environment, how long he expects to wait to get the return and hold the investment, availability of information for the underpinning investment decision and how he is going to analyze and interpret the available information.

According to the financial theory of Efficient Market Hypothesis (EMH), in a perfectly efficient market, all the information about the company's share price and return is reflected from the market price of that share[6]. However, due to the market imperfection in the real world, all the available information may not be actually reflected in the share price. In that case the individual will be able to make a sound decision on equity investment by systematically analyzing the available information.

Shares as a Short Term Investment Source

If the investor's interest is to hold an investment for a short period to get the return as a capital gain, he may not look into details of the company's growth, profitability, and cash flow when deriving conclusions. These short term investors buy stocks because the share prices are going up. Investors do not bother about the price they pay for shares because they expect someone else to pay a higher price in a month's or a week's time. However, the downside of this decision is that when the spell fades, there can be nothing to support the shares.

Market price per share which can be depicted in a graph (as shown in Figure 1) over a period of time to make a stock trading decision is called technical analysis. The whole point of technical analysis is that the charts showing past price movements are meant to reveal patterns which indicate future price movements. The investors tend to buy at dips expecting future prices will increase and tend to sell at peaks by hoping future share prices will decline. Investors thus assume market dips are not a cause for panic but buying opportunity[7].

5 Jayakody P, Financial Scandals: Who takes the responsibility? Financial Times 26.10.2008 http://sundaytimes.lk/081026/FinancialTimes/ft3038.html lastly retrieved on 10.09.2009

6 There are three common forms in which the efficient-market hypothesis are commonly stated — weak-form efficiency, semi-strong-form efficiency and strong-form efficiency, each of which has different implications for how markets work. Brealey R, Myers C., Marcus A.J., Fundamentals of Corporate Finance 3rd ed McGraw- Hill Irwin, New York America. PP 350-358

7 Coggan.P, Volatility unvanquished ,Financial Times, 09.04.2000

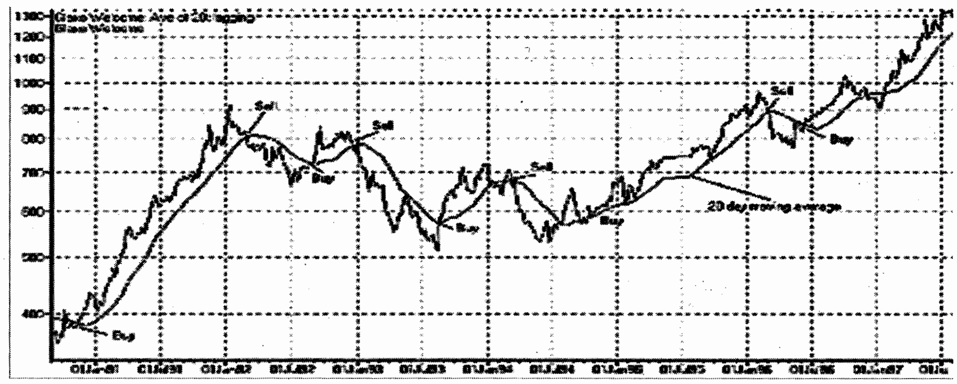

Figure1 Source: Glaxo Welcome share prices with buy and sell signals London stock exchange http://www.gsk.com/investors/share-price-charting-tool-ny.jsp

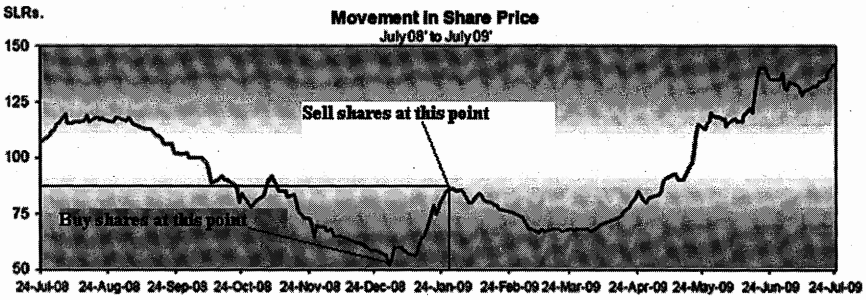

Figure 2: DFCC Bank share price movement during one year 24.07.2008 – 24.07.2009

If an investor wishes to hold his equity investment in DFCC Bank PLC for a shorter time period to realize a capital gain by selling shares at a higher price than the purchase price, and if he tries to plot a graph with past six months' data on daily price fluctuations (i.e. period beginning from 24th July to 24th December 2008) he will be able to identify that the trend of market price tends to decline over the period so it is better to buy shares at the lowest share price at Rs.50 where he anticipated no more drops in prices (Figure 2). After his investment if he continues to plot the graph on price movements he will be able to realize an increase in market prices gradually and after one month of the investment share prices will rise to Rs.85. He will be able to earn a profit of Rs. 35 per share simply holding the investment for nearly one month[8]. These kinds of investments are often mentioned as growth stocks because investor expects to make a profit out of an increase in the share price rather than holding for a longer duration to get a return in the form of dividends.

The philosophy behind technical analysis is in sharp contrast to the Efficient Market Hypothesis (EMH) Technical analysis has lesser relevance in the Sri Lankan stock market since Sri Lankan stock market indicates Weak form EMH[9]. In weak-form efficiency, future prices cannot be predicted by analyzing price from the past. Excess returns cannot be earned in the long run by using investment strategies based on historical share prices or other historical data. Technical analysis techniques will not be able to consistently produce excess returns, though some forms of fundamental analysis may still provide excess returns. Share prices exhibit no serial dependencies, meaning that there are no "patterns" on share prices. This implies that future price movements are determined entirely by information not contained in the price series. Therefore, prices must follow a random walk.

8 DFCC Bank research report by Capital Trust Securities (Pvt) Ltd issued on 04.08.2009

9 http://www.incademy.com/courses/Technical-analysis-II/Classic-interpretation-of-moving-averages/6/1032/10002 lastly retrieved on 10.09.2009

Shares as a Long Term Investment Source

If the investor wishes to purchase shares to hold them for a long period and willing to have a steady cash flow generation through dividends pay by the company in interim and year end basis he needs to analyze systematically the profitability, growth potential, liquidity, leverage of companies to understand whether the company has a sustainable future. Further, he needs to gather information about the industry position, competitors' performance against the company and changes in the variables which affect in market performance. This will enable the potential investor to understand the real value of a share, as opposed to its market price . The intrinsic value or real value of a company share which investor wishes to purchase may include other variables such as brand name, trademarks, and copyrights that are often difficult to calculate and sometimes not accurately reflected in the market price. Thus, there can be a gap between market capitalization (i.e. what investors are willing to pay for the company) of the company and intrinsic value (i.e. what the company is really worth). Both qualitative and quantitative data are necessary for an investor to evaluate the company's intrinsic value to judge the viability of the long term investment decision.

Finding qualitative data is for the basic rights of the company which can often be found out from the annual reports published by the company. Even before an investor looks at a company's financial statements or does any research, one of the most important questions that should be asked is: What does a company exactly do? This is referred to as a company's business model – it's how a company makes money. He can get a good overview of a company's business model by himself. Unless he understands the company's business model, he doesn't know what the drives are for future growth, and he leaves himself vulnerable to being blindsided. Another business consideration for investors is competitive advantage. The investor can visualize the company's future prospects by Chief Executive Officer's report which is normally place in the annual report that gives a fair idea about the new businesses that are going to undertake and the progress of ongoing businesses.

Corporate governance described in the annual report illustrates the policies in place within an organization denoting the relationships and responsibilities between management, directors and stakeholders. The purpose of corporate governance policies is to ensure that proper checques and balances are in place, making it more difficult for anyone to conduct unethical and illegal activities. Corporate governance policies typically cover a few general areas: structure of the board of directors, stakeholder rights and financial and information transparency. This aspect of governance relates to the quality and timeliness of a company's financial disclosures and operational happenings. Sufficient transparency implies that a company's financial releases are written in a manner that shareholders can follow what management is doing and therefore have a clear understanding of the company's current financial situation.

Auditors' report will ensure whether there are any material problems in the financial statements prepared by the company which is very much essential for an investor since he is going to use the financial statements to make his decision on investment which can otherwise go wrong due to the reference of inaccurate information.

The investor can gather quantitative information from company's financial statements. These financial statements consist of income statement/profit and loss account, balance sheet, cash flow statement, changes in equity, accounting policies, notes, disclosures, and financial summary of previous years. The investor can easily utilize these financial statements to judge the important business aspects like profitability, liquidity, long term debt and management efficiency. The investor will not get any meaning if he tries to compare

9 Abeysekara, S.P.2001, "Efficient Market Hypothesis and Emerging Capital Market in Sri Lanka evidence in Colombo Stock Exchange", Journal of Business Finance & Accounting 28(1) & (2) January/March, PP 249-261

10 Little K, Tools of fundamental analysis, http://stocks.about.com/od/evaluatingstocks/a/Fundanatools1.htm lastly retrieved on 08.09.2009

numbers on the basis of year by year, so numbers can be put into ratios prior to comparison. He can see the composition of gross profit, operating profit before tax, and profit after tax when compared to sales. This comparison will give him an overall understanding on how profit has diluted over the value additions which indicates the efficiency in operational activities compared to previous years and industry averages.

Balance sheet information provides him certain indications on the company's financing sources and asset base. This will indicate the company's financial position and cash reserves' availability. Here he can get a rough idea on the company's ability to pay dividends in monetary terms. Further, balance sheet information reveals company's long term liabilities. This information is valuable for an equity investor to assess the risk of the investment. If the company has high long term liabilities when compared to ordinary share capital, there is a possibility of future dilution of profit retain for the company to pay dividends since interest payments get the priority over dividends.

Another key point for an investor is to look at the company's profit attributable to ordinary shareholders. These profits are attributable to ordinary share holders which are often called earnings. These indicate the company's dividend payment capacity. Increase in earnings generally leads to a higher stock price and, in some cases, a regular dividend. When earnings fall short, the market may hammer the share price. Theoretically, a company's share price should increase if its earning continues to rise. However, this doesn't always happen[iv]. One reason is many investors aren't concerned about the value. Instead, they're concerned with price trends on a chart.

An equity investor holds his investment for a long period purely with the intention to get steady cash flow in the form of dividends. He can anticipate future dividend income by simply analyzing past years' dividends per share to get a rough idea on company's dividend policy. This will help him to evaluate the stability of his income source. Before starting the investment, if he compares the annual dividend return to the market price of the share which he is willing to purchase, he can identify the return in percentages and this is very much essential to compare with the return derive from other investment opportunities available for him to decide which investment is lucrative.

As shown in Figure 3 over the last 10 years, the share prices of these holdings have not kept pace with the companies' earning growth. For an investor, this is a great indicator of value. If he has realized the earnings potential of these companies which have severely undermined by the market over the time period, he will be able to buy shares at a lower price which give fair dividends per share and in the long run share prices will increase after market realizes these companies earning potentials. The value driven investor should be patient enough to stay until such a time

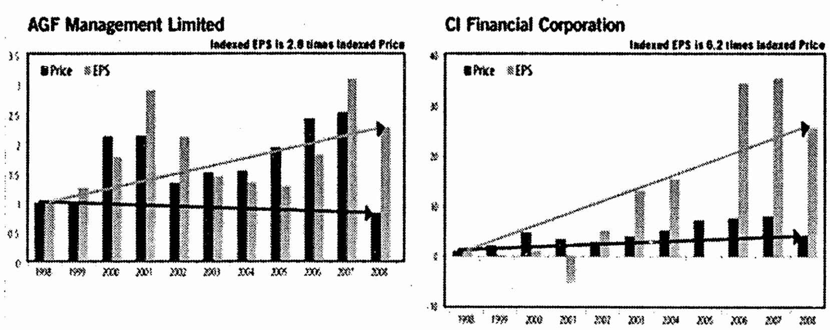

Figure 3 Source:-Earnings per share and dividends per share performance over ten years in AGF Management Limited and CI Financial Corporation London stock exchange

Common Pitfalls

These analyzing tools used for decision making discussed in this article have its own weaknesses. They purely focus on historical share price movements and try to incorporate in the short term buying and selling decisions. These may sometimes make the investor late because he tries to wait and see what's going on.

Long term equity investment decision is based on the information published by the company and that may not be highly desirable for an individual investor, because published information tends to be biased toward the company, which tries to highlight the overwhelming performance that might hinder the true picture of the company from the investor.

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