INDUSTRIALES PUERTO RICO
MANUFACTURA SERVICIO COMPETITIVIDAD
Volume 1 | Issue 3 | April 2019

BIRLING CAPITAL ADVISORS, LLC

The Mercurial Investor©

4 FORECASTS, 6 THEMES & 6 REACTIONS FOR Growth

As we share this issue of The Mercurial Investor, we note that we are ten years into the bull market, valuations are full, and volatility has increased significantly.

Currently the U.S. stock market cap to GDP ratio is near all-time highs. The market cap to GDP ratio is, ($26.1 trillion / $17.2 trillion) x 100 = 151.7%. In this case, 151.7% of GDP represents the overall stock market value clear indication that is overvalued. However, as the Federal Reserve Bank changes its view from easing to tightening, some dislocations and volatility will continue. Be very cautious with your investment plans. For this issue Birling Capital has outlined four forecasts that will have significant implications for global markets and Puerto Rico.

Forecast 1: Technological Disruption to double down: As technology changes the alteration to the status quo is due to highly disruptive in the next five years. More often than not the way the technology impacts the economy is more about the changes it creates in society than the actual technology. "Game Changing Technology" will both alter and increase the efficiency of people. Game Changing Technology includes robotics, smartphones and artificial intelligence. Technology will make existing tasks more even more accessible and faster than ever before.

Key Enabling Technologies include aerospace, agriculture, automotive, building construction, food, healthcare, mining, minerals, oil and gas, specialty chemicals and textiles.

Some of the disruption technologies include:

- **Web 3.0 –** this is the next iteration of the internet. It will use technology to capitalize on interactivity, and doing away from words using Artificial intelligence.
- **The market of One-** this trend will create mass personalization, and the key is doing away from current target marketing and meet the individual needs of every customer.
- **Voice Technology-** as much as we hate to use computerized voices that answer phones and perform other tasks while creating an entirely new ecosystem of marketing, branding and consumer engagement with the voice.

Forecast 2: 68% of the world population projected to live in urban areas by 2050:

The usual cycle of people from the rural towns filling the employment gap in the cities will have run its course. In most developed economies are likely to see a more balanced approach to urban and rural growth, with technological and altering working behaviors in societies with aging populations like Puerto Rico make urban living a choice rather than a necessity.

Today, 55% of the world's population lives in urban areas, a proportion that is expected to increase to 68% by 2050. Projections show that urbanization, the gradual shift in residence of the human population from rural to urban areas, combined with the overall growth of the world's population could add another 2.5 billion people to urban areas by 2050, with close to 90% of this increase taking place in Asia and Africa, according to the United Nations.

Today, the most urbanized regions include Northern America (with 82% of its population living in urban areas in 2018), Latin America and the Caribbean (81%), Europe (74%) and Oceania (68%). The level of urbanization in Asia is now approximating 50%. In contrast, Africa remains mostly rural, with 43% of its population living in urban areas.

Forecast 3: Improved Statistical Data = Superior Education:

The world is making remarkable progress towards ensuring quality education for all. In 2010, 63 percent of children of adequate age were receiving early childhood or primary education. By 2016, that proportion grew to 70 percent, meaning that millions of more children were now going to school. However, beneath these positive developments, better data helped to reveal a global learning crisis.

A 2017 study by the UNESCO Institute for Statistics found that 617 million children and adolescents – six out of every 10 – are not reaching minimum proficiency levels in reading and mathematics. This means that more than a half – 56 percent – of all children would not achieve minimum proficiency levels by the time they should be completing primary education.
What is even more worrying, roughly two-thirds of the 617 million children who are not learning enough, are attending school. This data made it clear to the world that getting children to school is only half the battle. The other challenge is to ensure that every child in the classroom receives the basic skills they need to thrive and develop.

In most countries they use the Programme for International Student Assessment better known as "PISA" and is a worldwide study by the Organization for Economic Co-operation and Development (OECD) in member and non-member nations intended to evaluate educational systems by measuring 15-year-old school pupils' scholastic performance on mathematics, science, and reading. It was first performed in 2000 and then repeated every three years. Its aim is to provide comparable data with a view to enabling countries to improve their education policies and outcomes. It measures problem solving and cognition.

Puerto Rico began to use PISA in 2015 and the results are concerning.

- In the reading exercises, the Puerto Rican students average 410 points, 83 points below the world average, this score indicates that 50% of those evaluated did not reach the minimum expected level in a 15-year-old adolescent.
- In science, Puerto Rican students reached 403 points, 90 points less than the world average. The qualification implies that 55% of the students did not reach the minimum level of performance.
- The least favored area was mathematics with 378 points on an average of 490, which means a negative difference of 112 points and 73% of students with performances below the minimum.
- Considering the three areas together, 44% of those evaluated did not achieve results compatible with level 2 or basic level and none reached level 6 or maximum performance level.

We need statistical data to transform our educational process.

Forecast 4: How soon we forgot the great recession

Arnold Schwarzenegger said: As long as I live, I will always remember that day when I raised my hand and took the oath of U.S. citizenship.

We must never forget that our biggest concern over the last several years has and will be debt. As Puerto Rico attempts to free itself from $73 billion in municipal debt and other sovereign nations, have taken on trillions of dollars of debt over the last decade. Corporate America and even Europe have followed suit, more recently using the current low rate environment to fund massive stock buyback programs. Using Grant's Interest Rate Observer: In the final quarter of 2007, just before the great recession, business debt as a percentage of GDP touched 68.8%, the highest on record since records began in 1945…. During and following the crisis via deleveraging, reduced the ratio to 64.7% by 2012. Today nonfinancial corporate debt rose from 71 percent of GDP to 92 percent.

We forgot that the economy works in cycles and cycles end, first gradually and then suddenly.

Theme 1: Mueller: Trump's campaign did not conspire with Russia:

The highly anticipated Special Counsel Robert Muller report was released by the Attorney General to Congress, and according to Special counsel Robert Mueller, the report did not find Donald Trump's campaign conspired with Russia. The investigation of whether the President committed obstruction of justice did not conclude the President committed a crime, but it also "does not exonerate him," William Barr was quoted. President Trump and his team call Mueller's report a full vindication. The decision on whether to prosecute the President on obstruction was made by Mr. Barr and Deputy Attorney General Rod Rosenstein as they determined the evidence was "not sufficient" to support prosecution. The President called it "complete and total exoneration." There is more to come on this matter.

Theme 2: Lyft Initial Public Offering (IPO) debuted this week:

Lyft that car sharing San Francisco company that began in 2012 had reached revenues in 2018 of $2.2 billion and losses of ($991 mm). It operates in 300 cities (Not San Juan) and provides 1,000 rides per day is going public. Their banker J.P. Morgan & Co. made the debut as a public company under the ticker "LYFT" on March 28 for $72 per share and the I.P.O. raised $2.3 Billion, which valued the company at $24 Billion. Early Friday the Lyft stock had increased by more than 20 percent and was trading at $87.24 per share.

Lyft Inc. had been expected to price its shares above the targeted range for its initial public offering, in a huge sign of outsize investor demand ahead of the IPO. While Lyft was conducting the traditional roadshows to market the new IPO, some analysts had stated that the stock priced above its previously targeted range of $62 to $68 a share and it entered the market at $72. While Lyft beat its arch-rival Uber to the market, Uber is due to announce its own IPO as early as April, and some bankers has valued Uber at more than $100 Billion. We must also note that these are only two of many similarly valued technology companies that have filed the documentation with the Securities and Exchange Commission and are expected to become public sometime later in the year. The list includes Pinterest, Postmates, Slack and some are predicting that Airbnb may also become public.

Stay tuned for more IPO's!

Theme 3: President Trump named Stephen Moore to the Federal Reserve Bank Board: President Donald Trump announced his plans to nominate his 2016 campaign adviser Stephen Moore. Moore is an American writer and economic commentator. He founded and served as president of the Club for Growth from 1999 to 2004. Moore is a former member of the Wall Street Journal editorial board. He worked at the Heritage Foundation during the period 1983-1987 and again since 2014. Moore is well known for advocating supply-side economics. He is a frequent columnist in the Wall Street Journal, The Washington Times, The Weekly Standard and National Review. He also wrote the book Trumpconomics and is a vocal critic of Federal Reserve Bank Chairman Jerome Powell.

According to some news reports Mr. Moore got nominated after he authored an op-ed titled "The Fed is a Threat to Growth" that appeared in The Wall Street Journal. In the column, Mr. Moore claims incorrectly that the U.S. is experiencing deflation and that the manner to correct it is to follow a rule adopted in the '80s by Paul Volcker. The problem with both assumptions is that it is false. The U.S. is not facing deflation, which means that prices are "falling," while most price indices show modest growth. Lastly, Paul Volcker never created the imaginary rule and when asked Mr. Volcker stated he did not adopt any such rule. We shall see how Mr. Moore fares in the Fed.

Theme 4: Global Equity Markets Impacted by Weaker than expected Economic data in Europe:
The pendulum of investor psychology took a beating last week as global equity markets after weaker economic data, and two significant warning signals showed up and with it rattled investors and provoked a selloff in stock mainly financials and industrials. The first indication of trouble was the fact that the yield on the 10-year German bonds (the European benchmark) turned negative for the first time since 2016. As a result, the 10-year treasury note yield fell below the return of the three-month treasury bills. This inverted yield curve is usually the first sign of a recession as frequently, the yield on long-term debt is higher and when we see this inverted yield curve appear is always the beginning of bad news.

European Union Indicators	2018	2019	2020
GDP growth (%, yoy)	1.9	1.5	1.7
Inflation (%, yoy)	1.9	1.6	1.8

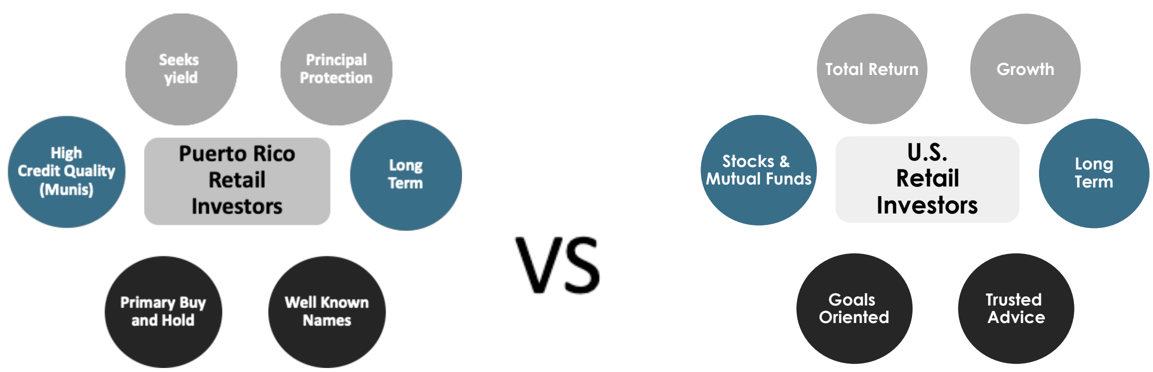
The other signal was the fact that the European economic outlook was reduced as weaker than expected economic date presented itself from France and Germany. The deepest slump in German manufacturing in more than six years has taken hold. The most significant pressures facing the European economy are caused by drastic changes in expert orders of manufacturers, as the combination of trade tensions, weaker growth and tariffs are becoming too much for the EU to take.

Theme 5: The Quarter Ends with a Bang, S&P records best quarter in ten years- Most Stocks finished the week, the month and the quarter with a bang, with most markets rising globally. The Dow Jones Industrial Average (DJIA) closed the week at 25,928.63, a rise of 426.31, or 1.67 percent, and; the S&P 500 closed at 2,874.40, a gain of 73.69, or 2.63 percent. The Nasdaq closed at 7,729.32, or an increase of 86.65, or 1.13 percent, Meanwhile, the U.S. Treasury's 10-year note went down to 2.40 percent or a decrease in yield of -12.00 percent. The S&P 500 marked its best quarterly return in the last ten years as it recorded an increase of 13%. The market reacted this quarter to the Federal Reserve Banks change in monetary policy towards rate hikes, the strong performance by the corporate sector in earnings, stock prices and job creation, renewed positivism towards a U.S.-China trade deal. This 1Q19 Is probably the best example we have seen of the benefit of taking a long term view to invest and why it matters to stock to your goals. As we often comment in our commentary the power in investing lies in having a well-diversified portfolio. We live thru a period like 4Q2018 that caused losses across the board, those that sold and got out only recorded losses, however those that remained in the market and put additional money as stocks and indices became cheaper, gained back their losses and recorded lofty gains.

Market Close Comparison	2/28/2019	3/29/2019	Change
Dow Jones Industrial Average	25,916.00	25,928.63	0.05%
Standard & Poors 500	2,783.91	2,834.40	1.81%
Nasdaq	7,532.53	7,729.32	2.61%
U.S. Treasury 10 Year Note	2.73%	2.40%	-12.09%

Theme 6: What Differentiates the Puerto Rico Investor to the U.S. Investor?

The profile of the Puerto Rico investors differs significantly from that of the typical investor in the United States. Puerto Rican investors have favored, and those include Government Bonds, Local Mutual Funds, Preferred Stocks and Banks Common stocks. One of the main goals for most investors was to seek tax-exempt income in most of their investments and thru the government bonds and most local mutual funds most investors were able to obtain a significant part of their investment income as tax exempt. Below is the chart that outlines the profile of the Puerto Rico investor and we believe that in the current market and with Puerto Rico in default this profile must change to one more like that of the U.S. investor that favors Stocks and Mutual Funds. As we examine most portfolios from U.S. investor, you will note that 75% of their portfolios if not more is composed of Stocks, Mutual Funds and Index Funds.



CPA Cesar Hernández-Monagas, Principal, Birling Capital

The Lease Conundrum

The main objective of the CPA's Corner is to keep you informed of significant changes occurring in the accounting world that could have an impact on your business. One of these upcoming changes is the new accounting treatment for leases.

Accounting Standard Update (ASU) No. 2016-02, Leases, is expected to add more than $1.2 trillion in off-balance-sheet leases to public companies' balance sheets. Under current practice, many lease obligations have no balance sheet impact as they are accounted for as operating leases with their payments included in an entity's income statement as rent expense and disclosed in the notes. For all leases with terms of more than 12 months, the revised standard requires right-to-use assets to be added to the assets section of the balance sheet and the present value of the related lease obligations to be included as liabilities. **The most significant impact of this accounting treatment is that it could make lessees appear significantly more leveraged and cause unprepared entities to violate their loan covenants.**

Lease classification:

The updated standard provides that the recognition, measurement and presentation of expenses and cash flows arising from a lease will continue to depend largely on its classification as a capital or operating lease:

- **Capital leases:** Lessees will amortize right-to-use assets separately from interest on the lease liability on the statement of comprehensive income. Their repayments of the principal portion of the lease liability will be classified within financing activities, and their payments of interest on the lease liability and variable lease payments within operating activities, in the statement of cash flows.
- **Operating leases:** Lessees will recognize a single total lease cost, computed to allocate cost of the lease over the lease term on a generally straight-line basis. All cash payments will be classified within operating activities in the statement of cash flows.

Disclosures:

The updated guidance also requires lessees to make additional disclosures to help users of financial statements better understand the amount, timing and uncertainty of cash flows related to leases. They must disclose qualitative and quantitative requirements, including information about variable lease payments and options to renew and terminate leases.

Under the updated guidance, some long-term leasing arrangements, such as service contracts and contracts with third-party manufacturers, may be complicated for entities to identify and assess who's in control. The new standard will require management to make subjective judgments about these complex transactions.

Effective date: You can elect to adopt the lease standard early. Otherwise, it is effective for public companies in 2019. The SEC is also allowing a one-year reprieve (similar to the exception for the revenue recognition standard) for an entity that meets the definition of a Public Business Entity (PBE) solely because its financial statements or financial information is included in another entity's SEC filing. These PBE's can also adopt the lease standard at the same time as private companies.

Private companies' and not-for-profit entities' financial statements must comply with ASU 2016-02 in 2019. These groups have until 2020 to apply the changes in their interim reports.

CPA Teresita Fuentes, Vice-Chair, Birling Capital

The Puerto Rico Tax Incentives Code and The Need for Uniformity

The controversial House Bill 1635, better known as the Puerto Rico Tax Incentives Code (PRPRTIC), is alive and kicking and will undergo another round of analysis and possibly "surgery" at our legislature. Already legislators from both sides are announcing that the project will undergo numerous changes and you can bet your bottom dollar that the resulting project will be significantly different if our legislator's intentions prevail.

The PRTIC was initially been envisioned as the resulting set of laws that survived the analysis performed by consultants hired by the Department of Economic Development to determine the effectiveness and rate of return of incentives laws. The review was designed to lead to the determination of a public policy that would conclude which laws would remain and which were to be revoked due to poor contributions to the economy. The analysis would also help in determining the resulting fiscal revenue savings from laws or tax credits to be revoked that could be used to fund the tax reform. As we all know, this was never fulfilled. The PRTIC was submitted too late for the legislature to review it and the tax reform was already undergoing surgery itself.

The purpose of the PRTIC is precisely to establish the legal and administrative framework within which the economic incentives are granted, to promote economic development and focus efforts where they are most needed. The PRTIC also establishes as one of its goals to create uniform procedures and rules to grant and measure the effectiveness of incentives. In some cases, the Secretary for Economic Development must coordinate with the Secretary of Treasury the approval of certain benefits such as conversions of tax exemptions. However, according to the PRTIC, the Secretary for Economic Development is the one entitled to deny tax and economic incentives when in his opinion the benefits do not justify the best economic interests of Puerto Rico. In order to maintain a healthy balance between the promoting arm and the fiscal agent, these two public officials should work together to determine who benefits or is denied benefits in ALL cases. On the other hand, no other municipal or state public official should be involved in this decision-making process, as this could delay the process and jeopardize the goal of uniformity.

The fact that some legislators are already stating the fiscal situation of the municipalities be considered when granting incentives is the reason for concern, as it may appear to be contrary to the principle of uniformity.

The Secretary for Economic Development is already warning that Puerto Rico's competitiveness cannot be jeopardized with these attempts to change the PRTIC, and he has all the reason to be concerned. One of the sensitive aspects of the PRTIC is maintaining the decision process centralized in order to avoid the numerous situations most exempt companies face when municipalities attempt to impute tax deficiencies, modify tax grant amendments among many other cases. These attempts are a direct threat to the investor and companies do not like to deal with surprises when rules are changed unilaterally because this impacts their budgets and their long-term planning.

Manufacturing companies fork up 40% of Puerto Rico's tax revenue. Therefore, it is easy to conclude that manufacturing incentives are the crown jewels of the PRTIC. The tax incentives policy cannot be undermined by the fact that municipalities have their own fiscal challenges. The tax incentives program has been the cornerstone of Puerto Rico's economic development and must be centralized and administered by well-versed professionals in these laws. To the extent these laws are left to the interpretation and policy-making of 78 different municipalities, we are doomed to fail the goal of uniformity.

Clearly, the greatest amount of capital investment, as well as job creation, has been spearheaded by manufacturing. This is true in Puerto Rico as well as the rest of the world. Governments around the world play a key role in the development of incentives and become facilitators of these programs which are the means to develop education, infrastructure and reduce social inequalities.

Companies evaluate government's commitments before deciding where to locate their operations and jurisdictions around the world compete for these products.

In a study conducted by Ernst & Young LLP for the government of Puerto Rico in 2010, several jurisdictions such as Ireland and Costa Rica were compared to Puerto Rico in various criteria. Puerto Rico's overall business tax competitiveness relative to the other jurisdictions prevailed over higher labor and utility costs. Although this may have changed over the years after the study was completed, it is important to recognize that to offset high utility and labor costs we need to leverage on low tax costs.

Ireland suffered the same economic challenges as Puerto Rico during 2010 with 15% unemployment and fiscal constraints that did not allow them to pay their bonds. However, with a clear policy of maintaining their incentives program alive against the pressure of the European Union, they managed to turn around their fiscal problems and reduce unemployment to 9% while growing the pharmaceutical industry to over $3 billion in investment. Key recommendations they followed: 1) maintain an ease of doing business, 2) strengthened business skills of workers by promoting collaboration between academia and industry and 3) a consistent message from the government favoring incentives.

The message our legislators must keep in mind is precisely that the message at the top must be a consistent message and the ease of doing business must be improved, not complicated. We will not be able to develop the growth of the manufacturing sector without these two goals.

The Final Word: Selling, Selling, Sold and it's Gone.

When and How to sell your business?

In the current business environment, it's always a good idea to be one step ahead of the herd. The world is a combination of business, technology, and politics that impact Business without mercy. When is the right time to sell or transfer market to the next generation of leaders?

Some key questions include:

- How much is my business worth?
- What could my exit strategy be?
- How do we transition to the next generation?

Background:

Currently, more than 60% of business owners are baby boomers, which are those born between 1946-1964, most of them are between the ages of 56-74 and by most metrics could be more than ready to sell their business.

The five types of entrepreneurs:

- **Lifestyle Entrepreneur**- It's those entrepreneurs that once they reach the lifestyle, they stop growing their business. For everyone, it's a different bar. For some it's having a house, beach house, boat, and plane, for others is being debt free for others is having 2,000 branches. The key is that once you reach that goal, they stop growing and may be time to sell.
- **Innovators**- it's the type of entrepreneur that creates an original idea and can turn them into a viable business model. Some come to mind like Apple, Google, Uber, Amazon, and Microsoft.
- **Hustler**- is the type of entrepreneur that starts small with little or no capital and works their way up, they are opposed to other stockholders, capital raises up or even partners. They focus a building their business from the ground up.
- **Me Too**- These entrepreneurs copy ideas from other entrepreneurs and improve them enough to make them feel new and innovative. Innovators are 50% hustlers and 50% lifestyle and won't stick to anyone's terms but their own.
- **Buying into Entrepreneurship** (BIE)- these are individuals that have the resources to purchase a business because they have both the wealth and savvy to do so. They more often than not avoid risks and don't worry about innovation and their focus is building upon what is already there. Cemeteries are full of all types of entrepreneurs, but the most common kind is the BIE.

What are the challenges of selling a business?

As that time becomes closer, you will face some challenges that include the business owner faces challenges that include:

- What happens to my family that works here?
- Is the money I have saved enough to help support my lifestyle?
- How do we clean up my financials to show the real business value?
- What happens to me next?

We can help every entrepreneur navigate the waters of selling the business, that include:

- Enterprise Valuation
- Business review and business planning
- Revenue and profit improvement
- Asset base analysis and optimization
- Corporate simplification
- Finance function transformation.

We are ready to advise you in solving one of the lives most demanding tasks, letting go of your business.

Selling, Selling, Sold and it's gone

We hope that you have enjoyed this issue of The Mercurial Investor © and we very much welcome your comments, thoughts, and ideas; you may reach us at frc@birlingcapital.com or 787-247-2500.

Francisco Rodríguez-Castro
President & CEO

BIRLING CAPITAL ADVISORS, LLC
Francisco Rodriguez-Castro, President & CEO • frc@birlingcapital.com
PO Box 10817 San Juan, PR 00922
• 787.247.2500 • 787.645.8430