

Quality of Earnings

Multi-Act Equity Research Services Pvt. Ltd. is an independent Equity Research organization based in India. Multi-Act's strong, unbiased and methodical Independent Equity Research for Investment Managers (IRIM) adds an extra dimension to the research conducted by both sell-side and internal buy-side teams, thus enabling fund managers to build their investment arguments and portfolios with more confidence. One of the aspect through which we add value to institutional and private investors is our Systematic Quality of Earnings (QoE) Analysis.

Objective

The objective of Quality of Earnings Analysis is to assess the extent to which a company's financials reflect economic reality and the sustainability of the past performance of the company without the need to continuously tap the capital markets.

Our Quality of Earnings Analysis comprises of

1. Understanding the accounting policies employed by the company vis-a-vis GAAP and global peers.
2. Evaluating if reported financials reflect the true economic earnings of the business.
3. Understanding sources of revenue growth and net profits to determine sustainability of growth and earnings.
4. Assessment of Balance Sheet to determine financial strength and liquidity risk.
5. Analysis of Corporate Governance to determine if minority shareholders are treated fairly. Corporate Governance analysis includes shareholding pattern, voting rights, pledged shares, related party transactions, promoter's background etc.
6. Assessment of capital allocation decisions especially with respect to Mergers & Acquisitions and buy back of shares to determine if management decisions have created valued for shareholders over long term.

Why Earnings Quality is Important?

Understanding of Quality of Earnings helps in avoiding landmines by staying away from fraudulent companies which pose risk of permanent loss of capital. It also allows the investors to look beneath the reported earnings and arrive at reasonable valuation based on economic earnings reflecting intrinsic value of the business.

Why Multi-Act

Over last two decades we have studied annual reports of more than 1000 companies. Based on our cumulative experience we have developed expertise in evaluating Quality of Earnings. Our analyst team which mostly comprises of Chartered Accountants has been trained to dissect the earnings in a focused, process oriented and methodological way.

Additionally we employ systematic tools for QoE evaluation. We have several checklists to quickly identify red-flags in companies. Several statistical scores like M-Score, F Score and AZS Score are computed as an independent check. We are in process of developing a proprietary score for QoE. Our multi-layered process of QoE analysis aids in keeping any behavioral biases in check.

A specialist like us makes it easier for you to access data on quality of earnings regularly, so you can focus your energies on your key-task of portfolio decision-making.

Case Studies: Poor Quality Companies culminating in permanent loss of capital for the investors.

The cases below are a few of the several in our database, where our analysis revealed poor Quality of Earnings and possibility of earnings manipulation.

1) An Indian company engaged in medical equipment business.

The company's 12-yr average RoE was 33% and RoCE 23%. Although, this seemed to be very appealing on the face of it, an analysis of the company's M-Score revealed that the earnings may not be reliable.

The M-Score of the company was in risky area in all the years, mainly due to high accruals, and high inorganic and organic sales growth. This was reflected in poor FCF generation which stood at -26% of the net earnings over its history. Negative FCF generation by the company was primarily because of high growth, high working capital and Capex.

For much of the period the market was quite happy to ignore the negative cash flow and was mesmerized by the growth of the company and the future potential. This led to piling of debt and dependency on capital markets for growth and survival.

Since tangible assets were few, the company may have been valued based on earnings by the market participants (as is the case for companies in that industry), but a deeper

analysis of reported fundamentals would have reflected that those earnings were suspect.

Our analysis also suggested adoption of debatable accounting practices like capitalizing R&D expenses, channel stuffing and routing transactions through net worth directly. Some questionable accounting treatment of goodwill upon consolidation of subsidiaries in FY 2012 further accentuated the risk pertaining to Quality of Earnings.

The market eventually recognized issues with the company, resulting in more than 90% correction in stock price. A look at the past shareholdings suggests that at least 20 Mutual Funds have held OC through 2005-2012.

2) An Indian E-commerce and software solution provider.

The Company prided itself on being the only profitable E-commerce company in India. However we observed multiple issues which raised concerns over Quality of Earnings.

Till 2015 a significant part of company's working capital was blocked in Advances for Advertisement which appeared to be too high for the company's size. Advance of FY 2012 was 40x that year's advertisement cost and 2x total SGA expense. 2012's advance would have been fully utilized only in 2016. Keeping a large sum of money (48% of total assets) with the advertisers for use after 4 years raises pertinent capital allocation questions.

Company had average outstanding receivables of ~13% which do not appear alarming for a general business. However considering the nature of company's business that is online sales with advance payments or Cash on Delivery and software solutions service on subscription basis, the receivables levels seemed unreasonable.

The company was also aggressive in capitalization of employee cost. These costs were capitalized as cost of Computer Software under Development. During 2014 to 2017 nearly 50% of total employees cost was capitalized.

Prior to the company's listing, in some years, the Company had a large quantum of financial dealings with a car dealership owned by its promoters. They were involved in both buying and selling transactions with these companies, despite having completely different businesses.

3) An Indian Pharma Company - Profit From Sale Evaporated

Last on the list is a mid-size Indian Pharma company. Towards the mid of 2014, it had sold significant part of its operating 'formulations' business to a leading industry player. While looking deep into its balance sheet, cash flow statement and schedules in notes to accounts, what caught our attention was that the full sale proceeds never reached the minority shareholders or lenders of the company; instead it appeared that the company made certain advances thereafter and which were also written-off during the same quarter itself. Similarly there were some write-offs of certain 'trade debtors' as well.

The same then was indirectly confirmed by way of auditor's qualifications in that regard.

On the top of that the said company also defaulted on repayment of principal and interest on certain deposits and sought time extension from CLB for repayments. That for a company, supposedly flush with sale proceeds of its substantial business segment is well, hard to understand.

Our questionnaire to the company management in August 2015 on these issues went unanswered.

Subsequently there have been more adverse developments in form of absconding directors, arrest of some directors etc. and stock price continues to be in free falling mode.

Case Studies: Assessment of Economic Earnings and their sustainability.

The cases below are a few of the several in our database, where there may not be a severe manipulation of fundamentals but the reported numbers do not reflect the underlying economics of the business.

1) Volatile sales growth of a Singapore based cosmetic company.

This company operates on a multi-level marketing model. The company sells personal care products. The personal care industry has been known to be stable as the companies tend to have steady sales as a result of consumers being habituated to the products.

The growth in sales of the company, however, was much more volatile than that of its direct competitors.

The main reason for the wildly fluctuating sales growth was that the company entered into a new market when an existing market slowed down. The first major market it entered was Singapore.

Singapore accounted for 76% of sales in 2001, but after years of de-growth, it was barely 3% of sales in 2017. The company got permission to enter China in 2016, which has been the key driver of sales growth in the last two years. This strategy of entering a new market when sales slowdown would not be unsustainable in long term.

Another issue we noticed was the inconsistency of disclosures. The company chose to report certain geographical segments when they performed well but chose to stop reporting them when they fared poorly.

This also raises a question regarding consumer preference. The company's model of chain marketing may push sales in the initial year or two but, the products are, after all, personal care products and consumer preference does matter. The sales growth spurts were coinciding with the increase in the rise of the company's memberships (revenue per member declined at a CAGR of 9.85% from 2004 to 2017). It highly depends on the recruitment of new members and their active involvement. Thus we concluded that the company would not be able to sustain its sales in long term.

2) Puzzling cost structure of a specialty additives manufacturer.

Additives give key characteristic to the final product. Additives used in minor quantities are very critical in terms of performance in end material, be it food, plastic or rubber products. Additives form just 1-2% of the total volume, but any irregularity in additives may render the entire batch of products useless. Thus customers prefer sourcing additives from established players as quality is significant concern over cost. Thus companies operating in specialty additives segment are expected to enjoy competitive advantage due to their expertise and R&D efforts.

The company under question claims to have 90% market share in the plastic and food additive segments in the global markets. It has reported average Return on Net Worth of more than 25% during 2013 to 2019. Thus business analysis and fundamentals indicated that it was a good quality company.

However deeper analysis of company's cost structure suggested company wasn't adding any substantial value to the purchased raw material and it might be acting like an intermediary between RM suppliers and end customers. Out of company's total cost 75% was cost of raw material, manufacturing costs of just 2.5% of sales indicated simple

manufacturing process. R&D cost of 0.1% of sales indicated lack of any substantial R&D and innovation by the company. With such cost structure it is difficult to believe that company possesses any expertise to protect itself from competitors.

One possible reason for low R&D and manufacturing cost could be that the company is enjoying benefits of R&D undertaken in earlier periods. However without sufficient reinvestment in R&D and innovation company will not be able to grow its business.

3) A wire and cable manufacturer in India showing high cost of debt.

While analyzing a manufacturer of cables and wires we observed that company's cost of debt was very high as compared to prevailing interest cost in India. The company reported its rate of borrowing as ~12%. However calculated effective finance cost based on average yearend balance sheet debt was more than 20%. It implied that either the company had to borrow at significantly higher than market rates due to its lower credit quality or the company had significantly higher debt during the year and on balance sheet dates it was window dressed to a lower level. In either case, it meant weak financial strength and high liquidity risk.