Pests infected earnings of an Agro chemical company

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Few weeks ago, an Audit firm resigned as statutory auditors of a Mauritius based material subsidiary of an Indian Agrochemical company. The reason mentioned was "In order to reorganize the audit process to improve productivity, at the request of the Company". The Indian sub-licensee audit firm of that main audit firm will continue to carry out the audit of group's consolidated financials of the Parent Indian agrochemical company.

The market reacted negatively to the news. Mr. Market's negative sentiment is stemming from some recent cases where sudden resignation of auditors brought spotlight on several issues in those companies. Some of the companies where auditors have resigned recently include – Reliance Capital, Reliance Home Finance and Vakrangee (PWC), Manpasand Beverages and Fortis Healthcare (Deloitte), ILFS Engineering and Construction (BSR and associates). So, out of turn auditor resignation is seen as one of the indicators of possible poor corporate governance and quality of earnings (QoE) issues.

Quality of earnings, quality of reporting and quality of corporate governance are few key metrics to understand the quality of management and the company. They show the character of the management and probability of fair treatment to minority shareholders.

In the given case, neither the company nor the auditors have expressed any negative observations leading to the auditor resignation. However, the subsidiary whose auditor resigned was a material subsidiary contributing around 20% to consolidated profit and was used to acquire a Japan based ago lifescience company. Considering the significance of the subsidiary and experience of other recent cases of untimely auditor resignations, market participants might have taken a cautious stance.

In our view auditor's sudden resignation can be a red flag but it is not a conclusive evidence of any issues in a company. At Multi-act we evaluate different other parameters such as related party transactions, shareholding pattern, extra-ordinary items, cash flow generation, leverage levels, group structure etc. to determine a company's Quality of Earnings, Corporate Governance and Capital Allocation.

Here is an evaluation of this company from Multi-Act's quality lens.

1. Complex subsidiary structure:

The company currently has a complex structure with 231 subsidiaries (including step down subsidiaries) resulting in lack of transparency and difficulty in analysing the financials of each subsidiary. *High number of subsidiaries currently is also due to acquisition of Japan based agro lifescience company in 2019. Management intends to reduce the number of subsidiaries to around 120-130 over next 2-3 years.*

In FY 2019 the company's standalone operations contributed only 39% to the consolidated sales while remaining 61% sales were through various subsidiaries.

Net margin of some of these companies are abnormally volatile (partly due to effective tax rate differences). While, high volatility in margins reduces our confidence on sustainability of the subsidiaries' profits and margins, *company management attributes this to the nature of operations whereby the company invoices raw material / API sales to its Mauritius and Hong Kong based subsidiaries which then raise sales invoice to other subsidiaries around the world who then sell the final product to the end customer. Transfer pricing regulations, pricing regulation in each country, Forex fluctuations etc impact these transactions and thus the margins.*

Net Margins	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Standalone Indian agrochemical company	5.2%	8.2%	8.4%	6.3%	3.4%	7.6%	4.8%
European subsidiary	1.4%	2.8%	1.2%	2.6%	9.2%	6.7%	-1.6%
Netherlands based subsidiary	-140.9%	180.4%	160.7%	-1.1%	235.3%	-20.0%	-333.3%
Brazil based subsidiary 1	-890.8%	-174.6%	579.1%	-833.3%	-553.5%	-360.0%	-400.0%
Mauritius based subsidiary	30.1%	47.1%	56.0%	27.2%	13.5%	7.9%	22.8%
Acquired Japan based agro lifescience company							-16.2%
Brazil based subsidiary 2	-0.4%	1.4%	5.5%	4.0%	3.4%	0.8%	-2.5%
Intra group	18.0%	12.6%	6.6%	25.0%	45.9%	41.1%	27.2%
Consolidated	**9.0%**	**9.8%**	**9.7%**	**10.5%**	**11.2%**	**12.1%**	**10.2%**

Among the key subsidiaries, Mauritius based subsidiary contributed ~ 9% to the consolidated sales and ~ 20% to the consolidated profit in last 7 years. During that period, the subsidiary's net margins showed a wide fluctuation of 56% in 2015 to 7.9% in 2018. ~10% of the total standalone sales are made to this subsidiary as related party transaction.

Net Profit mix	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Standalone Indian agrochemical company	25.8%	40.1%	40.1%	28.1%	13.6%	26.4%	18.4%
European subsidiary	1.4%	2.4%	0.9%	1.6%	4.0%	2.8%	-0.6%
Netherlands based subsidiary	-0.5%	0.6%	0.5%	0.0%	0.7%	0.0%	-0.5%
Brazil based subsidiary 1	-2.9%	-0.6%	1.7%	-2.1%	-1.6%	-0.9%	-0.5%
Mauritius based subsidiary	17.7%	23.2%	30.4%	23.9%	18.1%	9.1%	17.5%
Acquired Japan based agro lifescience company	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	-1.6%
Brazil based subsidiary 2	-0.5%	2.0%	7.1%	7.9%	6.5%	1.3%	-5.1%
Intra group	59.1%	32.3%	19.4%	40.6%	58.7%	61.3%	72.6%
Consolidated	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

2. Large extraordinary items:

The company has charged large extra-ordinary expenses to its income statement in many years. Since these are non-recurring charges, market participants often exclude these items to determine the company's normal profitability. However, in case of this company, these charges are quite frequent in nature raising doubts over the quality of earnings. Cumulatively these extraordinary items formed ~ 10% of cumulative ordinary PAT and wiped out ~ 8% of the net worth. Including the goodwill write off upon merger of a subsidiary, which was directly routed through net worth (refer note 3 below), these extraordinary charges would have wiped off 33% of the net worth.

Particulars	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Restructuring Costs	227	119	157	128	471	363	165	315	247	
Prior period adjustments	-	105	228	203	203	79	191	119	-	-
Prov for diminution in value of Investment					85	85	85			
Profit on sale of associate/subsidiary						(483)		(230)		
Product contamination and counterfeiting							109	60	111	
Inventory provision							185	153		
Acquisition and integration costs										3,171
Litigation expenses										646
Inventory acquired and w/o										3,757
Others			(19)		113	60		272	179	17
Total	227	224	366	331	872	104	734	689	536	7,591
As % of PAT	4%	4%	6%	4%	8%	1%	5%	4%	3%	34%
As % of Net Worth	1%	1%	1%	1%	2%	0%	1%	1%	1%	5%

3. Routing of income / expense directly through net worth:

The company has often resorted to account for some income / expenses directly through net worth rather than income statement. While the treatment for some items could be due to accounting regulations and some could be due to company's own discretion but ultimately, they have resulted in major items escaping the income statement.

Particulars	**2008**	**2017**
Opening Networth	**14,947**	**58,890**
Add Profits	2,575	17,270
Less: Dividend	(568)	(2,170)
Add: Conversion of FCCB	416	
Equity Issued	10,528	37,950
Revaluation of non-controlling interests / Goodwill write off		**(36,930)**
Write-off of product acquisition expenses	**(5,333)**	
Foreign Currency Reserve change		(10)
Others	(190)	(1,260)
Deemed Dilution loss		230
Closing Net-worth	**22,375**	**73,970**

** Amounts in INR mn*

An interesting observation here is that on couple of occasions the discretionary write offs have coincided large credits to the net worth. In 2008 and 2017, the effect of large write offs and revaluation losses on net worth was minimized due to issuance of equity in those years.

While these accounting treatments would be in line with accounting standards, they might not reflect the true economic picture of the company's financial position.

4. Capital allocation - Acquisition of Japan based agro lifescience company:

a. Consideration & mode of transaction - Company acquired Japan based agro lifescience company in July 2018 who is a global provider of innovative crop protection solutions, with strong presence in bio solutions (among top eight global players) and seed treatment (ranked fourth globally).

Consideration for the acquisition amounted to INR 314.5 bn (~USD 4.2 bn) which was funded through issuance of equity (USD 1.2 bn) & debt (USD 3 bn). Company had issued equity of Mauritius based key subsidiary to Abu Dhabi Investment Authority & TPG Capital (PE Investors). These entities now hold 11% stake each, while the company has 78% stake. The debt has a bullet maturity of 5 years. However, during Q4FY19, the management swapped USD 1,500 mn loan to EUR loans and USD 400 mn debt to JPY loan.

b. Valuation and impact – Acquired company has had much lower margin as compared to the Indian agrochemical company and also had a moderate sales growth in last 3 years. The company had paid ~20x EV/EBIT multiple (based on 2018 financials) for the acquisition, which seems to be expensive when we compare it with company's own LT EV/EBIT multiple of 11.4x. Step up value (revaluation of asset over the book value) paid is 62% of the book value of assets. Over and above that, company has paid ~48% of the purchase consideration towards goodwill.

Financials of Acquired company in USD mn				
	2015	**2016**	**2017**	**2018**
Revenue	1,742	1,816	1,897	1,956
Growth (%)	*n/a*	*4%*	*4%*	*3%*
EBITDA	343	368	388	424
D&A	171	186	199	215
EBIT	172	182	189	209
EBIT (%)	*9.9%*	*10.0%*	*10.0%*	*10.7%*
Tax @ 20%	34	36	38	42
Net Profit	138	146	151	167
NPM (%)	*7.9%*	*8.0%*	*8.0%*	*8.5%*

Valuation Multiples	**Acquired entity**		**Indian Parent company**
	2017 financials	**2018 financials**	**LT Avg.**
EV/EBITDA	10.8	9.9	8.7
EV/EBIT	22.2	20.1	11.4

Particulars	**Book Value of acquired entity**	**Step Up**	**Acquisition Value**	**Step up as % of BV**
Fixed Assets + Investments	9,620	1,410	11,030	15%
Intangibles	31,780	89,400	1,21,180	281%
Net Working Capital	71,620	7,690	79,310	11%
Debt	(8,070)	-	(8,070)	
Others	(3,480)	(35,740)	(39,220)	1027%
Total	1,01,470	62,760	1,64,230	62%
Goodwill			1,50,340	
Total Purchase Consideration			3,14,570	

** Amounts in INR mn*

c. Valuation adjustment of inventories - The value of the acquired inventories in the books of Acquired entity was INR 32,890 mn, and it was acquired at a step up of INR 8,690 mn. As per company management, this was a Purchase Price Allocation (PPA) adjustment required as per the accounting standard to record inventories at fair value. However, during Q4FY19, the company again adjusted INR 4,420mn of the inventories as 'unwinding of step up value of acquisition inventory (Fair Value). Further, an amount of INR 4,100 mn was adjusted in Q1FY20. The rationale given by the management was to record the inventory again at cost and thus show actual profits upon their sale.

Particulars	Amount (Rs. Mn)
Book Value of inventory acquired	32,890
(+) PPA Step up	8,690
Acquisition Value	41,580
(-) Unwinding of PPA value	
Q4FY19	4,420
Q1FY20	4,100
Total Unwinding	8,520
Net Acquisition value	33,060
-	
Unwinding as % of PPA Step up	98.0%
Unwinding as % of Acquisition value	20.5%

Paying up high valuation multiples, recognizing large intangibles and subsequent write off of acquired assets could possibly indicate poor capital allocation decision.
In the context of the said acquisition, it's worthwhile to add that the Management has guided that the company seems to be on track of achieving the expected synergies arising from the acquisition. It would be in best interest of the investors to track this metric closely in the coming quarter(s).

To conclude, the Mauritius subsidiary is a material subsidiary contributing ~ 20% to net profits and is also a direct holding company of recently acquired Agro lifescience company. Thus, fair reporting of the subsidiary's financials is crucial for the company's consolidated financial statements. Resignation of auditor in isolation might not be a cause of concern, however investors should be cognizant of the red flags raised by other issues in the company.

Complex web of subsidiaries makes it difficult to analyse the group activities, high fluctuations in margins and frequent extraordinary items raise a question on Sustainability and Quality of Earnings and large adjustments of acquired assets raise concerns on the company's capital allocation practices.

Such issues have had history of triggering permanent loss of capital for investors. For institutional investors, this may even lead to reputational loss. It is thus important for investors to be aware of such potential investing landmines.

Multi-Act has embedded robust checks in its research process to flag off potential accounting, quality of earnings or corporate governance in companies' financials. This is to ensure that investors understand the gravity of these issues and are aware of potential risks that may emanate from them.

Here is a case study where an e-commerce company, which was part of Nifty Quality Index. It had found its way into institutional portfolios, ultimately causing some of them some permanent loss of capital and reputational loss.
https://multi-act.com/corporate-governance-issues-at-an-e-governance-business

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