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In the last few months, the term 'unprecedented' was at the centre of every business conversation. Companies' managements and investors are still trying to assess the impact of unprecedented global pandemic and unprecedented lockdowns on global economies and individual businesses.

Against that backdrop, a few companies have booked impairment charges on their assets in the March 2020 quarter. Some other companies may follow suit and we may see a lot more one-time impairment charges in coming quarterly results.

As a long-term investor, how should you view companies taking impairment charges? Should you punish the company for recognizing such huge losses or be lenient with it considering the 'unprecedented' global pandemic and resulting lockdown was beyond management's control?

The answer to that question lies in another set of questions.

Has the global pandemic caused these impairments or is the company using it as an excuse to clean up the books? In difficult times when earnings and share prices are already depressed, big bath accounting in the form of impairment of assets gives an opportunity to boost future earnings. The large write-off is likely to be discounted by the market as a one-time expense and in subsequent years the company gets to charge lower depreciation on the written down value of that asset, resulting in higher earnings.

To gauge if the impairment has been caused by the global pandemic, an investor should try to assess if the company's business environment has materially and permanently changed. Would that business have run smoothly, if there was no global pandemic? And is the percentage of assets impaired in line with the percentage of business loss?

Let's evaluate the impairment charges recognized by a temporary staffing services company.

In Q4 FY2020, this company impaired Intangible Assets (largely acquired customer relationships) and Goodwill of nearly Rs. 6.4 billion. That is equivalent to 44% of their total investment in acquisitions and it has wiped out ~22% of the company's net worth. Management attributed the impairment to Covid-19-triggered business disruption and future uncertainty. They also indicated that there might be further impairment in the coming period.

It is a highly acquisitive company with 20+ acquisitions in its last 13 years of existence. Analysis of the company's cash flows shows that the company's cash outflows for acquisitions are more than 8 times its operating cash flows. The number of acquisitions and amount invested suggests that it is an acquisition-oriented company.

Aggregate Cash Flows since FY 2011	Amount (Rs in millions)	As a % of OCF
Operating Cash Flows before WC Changes	8,182	
Less: Working Capital Changes	(6,964)	-85%
Operating Cash Flows	1,218	15%
Less: Capex	(2,861)	-235%
Less: Acquisitions	(10,005)	-821%
<b>FCF Available for Debt Repayment and Share Buyback</b>	<b>(11,648)</b>	<b>-956%</b>
Share based purchase consideration	4,603	
<b>Total consideration for Acquisitions</b>	<b>14,608</b>	

Source: Company, Multi-Act Research

Management's rationales for the acquisitions were mainly diversification into different business verticals and geographies. In some of the acquisitions the intention was to turnaround the acquired companies.

Staffing is an asset light service business. Important drivers of the business like employees, customer contracts and business relationships are not reflected in balance sheets. Thus, most of the consideration paid was towards intangibles. To assess fairness of price paid, one must look at earnings based multiples.

Below is a summary of the company's 5 largest acquisitions during FY 2017 to FY 2019.

Date of Acquisition	Acquiree	Purchase consideration (PC) (Rs in Millions)	Goodwill as % of PC	Price/Sales	Price/Earnings	Net Margins in the year of acquisition	Net Margins FY 2019
Dec -16	Acquisition MS	7,085	84.8%	2.21	70.0	3.2%	0.8%
Feb -17	Acquisition CS	2,547	46.6%	0.73	8.8	8.3%	-1.1% *
Nov -17	Acquisition VC	578	43.8%	0.54	34.8	1.5%	-0.2% *
Nov -17	Acquisition CB	3,217	21.6%	0.52	10.3	5.0%	-1.1% *
Feb -18	Acquisition MI	1,448	51.9%	1.03	Nmf (loss)*	-3.5%	1.7%

Source: Company, Multi-Act Research

## Questionable Capital Allocation, Questionable Impairment!

Goodwill comprised ~50% of the consideration in these five acquisitions. This goodwill is over and above the estimated fair value of acquired company's 'Customer relationships'.

Between 2017- 2019, the company traded at an average Price/Sales multiple of 1.9x and Price/Earnings multiple of 59x. Its average net margin during that period was 3.2%. Compared to the company's own valuation, prima facie, the acquisition multiples do not seem that high.

Let's see how these companies performed post acquisition.

Subsidiary	Contribution in FY 2019 Consolidated Revenue	FY 2016	FY 2017	FY 2018	FY 2019
<u>Part 1 of Acquisition MS^</u>	1.85%				
Revenue Growth			11.3%	22.5%	-8.1%
Net Margin		2.0%	2.5%	1.8%	0.8%
RONW		25.3%	26.9%	19.3%	6.0%
<u>Part 2 of Acquisition MS^</u>	2.54%				
Revenue Growth			27.9%	20.6%	45.5%
Net Margin			3.5%	4.7%	0.8%
RONW			42.6%	41.0%	9.7%
<u>Acquisition VC</u>	1.26%				
Revenue Growth			5.1%	27.3%	7.7%
Net Margin		5.2%	6.9%	1.0%	0.4%
RONW		34.1%	32.1%	4.5%	0.2%
<u>Indian entity within Acquisition MI</u>	1.54%				
Revenue Growth			-5.5%	-15.5%	-0.8%
Net Margin		-5.0%	-16.1%	-15.4%	3.5%
RONW		-10.4%	-50.8%	-67.6%	16.4%

Source: Probe 42 database, Company and Multi-Act Research

The above table shows us that even before the global pandemic, margins of Acquisition MS and Acquisition VC were declining for two years. An Indian subsidiary of 'Acquisition MI' has been continuously losing revenue and incurring huge losses.

In the March 2020 quarter, the company impaired 55% of its investment in Acquisition MS and 64% of their investment in Acquisition VC.

Poor performance of most of the acquisitions and subsequent impairment suggest poor capital allocation.

## Questionable Capital Allocation, Questionable Impairment!

Another incident of the company's questionable Capital Allocation is its investment in an unrelated business of a Sports Club.

In FY 2019 the company acquired 70% stake in a Sports club for Rs 100 million and further advanced loan of Rs. 125 million to it. Part of the advance was paid back during the year and as on 31-03-2019 outstanding amount of loan and accrued interest amounted to Rs. 177 million.

Immediately in the next year in Q4 FY 2020 the company wrote off Rs 243 million pertaining to equity investment in and loans given to the Sports club, citing absence of economic viability. Write off in excess of the opening balance indicates that additional investments were made in that entity during FY 2020.

Particulars	Rs in Millions	As % of Net-Worth	As % of Total Assets
Investment and loans given and interest outstanding as on 31-03-2019	177	0.7%	0.4%
Write off in Q4 FY 2020	243	1.1%	0.5%
Excess write off	66		

Source: Company, Multi-Act Research

As compared to the company's total size, the amount invested in the Sports Club is not significant. However, when the company's own balance sheet is highly levered, rationale for diverting funds to unrelated businesses is difficult to understand.

The following table shows the impact of the company's capital allocation decisions on its financial performance.

Particulars	2015	2016	2017	2018	2019
Operating Profit Margin - Standalone	4.8%	4.4%	4.8%	4.6%	4.7%
Operating Profit Margin - Consolidated	4.6%	4.3%	4.7%	4.5%	4.0%
ROCE - Consolidated	19.7%	18.9%	11.2%	7.5%	8.9%
Asset Turnover - Consolidated	2.9	2.8	1.8	1.3	1.7
Adjusted Asset Turnover (excluding Goodwill from Total Assets)	3.4	3.3	2.2	1.6	2.2

Source: Company, Multi-Act Research

Operating margins for the standalone business have been fairly stable, however, consolidated margins have been showing declining trend indicating poor margins of acquired companies. High proportion of Goodwill upon acquisitions has driven the asset turnover ratio down and consequently lowered the Return on Capital Employed. Asset turnover is also impacted by an increase in cash balance post IPO in FY 2017.

### Conclusion

Decline in revenues and margins of acquired businesses post acquisitions raises questions on management's execution abilities especially when the rationale for acquiring the businesses was to turn them around. Moreover, acquired businesses' weak performance since FY 2018 also suggests that these investments were problematic even before the world was hit by the global pandemic. Covid-19 might have just bought the capital allocation issues on surface.

## Questionable Capital Allocation, Questionable Impairment!

An investor should also note that the impairment has reduced shareholders' net worth by nearly 22%. Further due to lower written down value of Customer Relationships, future yearly amortization expenses would be lower by Rs. 153 million. This would boost the company's RoE by 224 bps and operating margin by 14 bps.

Particulars	Pre-Impairment	Post-Impairment	Impact (bps)
Operating profit Margin	3.72%	3.86%	14
ROE	7.96%	10.20%	224

Source: Company, Multi-Act Research

### Legends

\*In case of Loss at PBT or PAT levels we have used PBT amounts to assess the true profitability of business

^ Two subsidiaries were acquired under acquisition MS

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