

[vc_row type="in_container" scene_position="center" text_color="dark" text_align="left" overlay_strength="0.3"][vc_column column_padding="no-extra-padding" column_padding_position="all" background_color_opacity="1" background_hover_color_opacity="1" width="1/1"][vc_column_text]While analysing a company engaged in operating a network of last-mile retail touch points for banking, insurance, e-governance, e-commerce services, we came across some notable issues concerning quality of earnings & corporate governance at the company. This note explains our findings on the same.

About the Company:

Company is a technology driven company providing last-mile retail touch points to deliver real-time banking, insurance, e-governance, e-commerce and ATM services to the rural, semi-urban and urban markets. These retail touch points (sometimes referred as “Kendras”) act as the “One-stop shop” for availing various services and products.

Quality of Earnings & Corporate Governance Issues:

1.Misreporting of Shareholding & Likely Manipulation of Exchange Volumes -

While analysing company’s shareholding pattern, we came across some misreporting within the annual report of financial year 2016. The shareholding pattern reported in Directors’ Report showed Non Promoter Institutional shareholding as 17.90%, while the shareholding pattern reported in Corporate Governance Report showed the same as 13.82%. (Auditors are required to comment on corporate governance report & not on directors’ report).

On further scrutiny, we also observed that the shareholding of some of the shareholders as on 31st March, 2015 was restated in the annual report of financial year 2016.

Shareholder	Shareholding for 31.03.2015 in		
	2015 AR	2016 AR	Difference
BP Trading	26.19	35.88	9.69
VND Bohra	6.68	9.67	2.99
NT Trading	4.93	11.98	7.05
HP Trading	19.17	19.60	0.42
SH Mercantile Co.	8.91	13.98	5.07
AVK Properties	10.05	12.54	2.49
ABR Trading Private Limited	3.53	14.38	10.85

ABR Trading Pvt. Ltd.	10.00	-	(10.00)
KT Properties	5.18	5.48	0.30
ACZ	-	0.03	0.03

(number of shares in millions)

Another important observation here was reporting of shareholders with very similar names as 2 different shareholders with different shareholding. For example, in financial year 2015 company reported two shareholders with names “ATC Trading Private Ltd.” (3.53 million shares) & “ATC Trading Pvt. Ltd.” (10 million shares). Similarly in its BSE filing for March 2015, company reported two shareholders with exactly similar names “ATC Trading Company Pvt Ltd” (one with 26.19 million shares & the other with 8.23 million shares). While this could be perfectly legal to have similar sounding name entities, it could give misleading signals from a good corporate governance perspective.

We also observed the volume of shares contributed by these entities as a % of total traded volume on both the exchanges to be significantly high at 39.3% & 12.0% in financial year 2015 & 2016 respectively.

A recent news article has also highlighted that between January 1 and June 30, 2016, a group of 22 investors related to each other as well as to the company were continuously buying and selling the scrip, accounting for 74.87% of market gross volumes on certain days. Also noteworthy is that 18 of these 22 had more than 90% trading activity in this scrip only.

Another interesting observation during our exercise was the difference between shareholding reported in annual report & shareholding reported in BSE filing for the quarter ended 31st March, 2016.

Shareholder	BSE Filing 2016	AR	Difference
BP Trading	22.80	25.79	2.99
NT Trading	14.40	21.56	7.16
HP Trading	12.73	17.73	5.00
SH Mercantile Co.	16.00	4.52	(11.48)
AVK Properties	10.05	11.63	1.58

(number of shares in millions)

Such gross misrepresentations in statutory filings raises concerns on corporate governance

practices, particularly from minority shareholder's perspective.

2. Investments in Subsidiaries & Subsequent Disposals -

Company had developed few software through one of its wholly owned subsidiary, with an accumulated investment of ~INR 500.5 million till 31st March, 2012. The said subsidiary was able to develop software like Document Management Services (DMS), Human Capital Management (HCM) and School ERP, which were to be commercialized soon. However in FY 13, company disposed this subsidiary for an amount of 'INR 500.8 million'. The sale of a subsidiary with potential of revenue generation to be sold off for a sum, very similar to its cost of investment again raises red flag on corporate governance practices.

Similar was the case with another subsidiary company, which was sold for INR 81.5 million in 2014 (cost of investments was also co-incidentally INR 81.5 million). This subsidiary had been allotted an Industrial plot admeasuring to 5 Acres from HSIIDC at IMT Manesar, Haryana, where the Company was planning to develop an IT Centre.

We don't have the details as to whom they were sold off to. 'If' the company sold these subsidiaries to promoters or some entities related to them, then the virtue of such transactions will be under cloud of questionable corporate governance practices.

3. Large Capex & Subsequent Write-offs -

In FY 2007 & 2008, company had incurred large capex of 100% & 67% of its annual sales respectively (amounting to INR 2.7 billion). However in FY 2009, company wrote off assets worth INR 493 million, raising question marks over efficacy of capex incurred in prior years.

SEBI also investigated the company & some of its officers for charges of insider trading for transactions just before announcement of Q4FY09 earnings (quarter in which assets mentioned above were written off). However SEBI couldn't get the conclusive evidence & dropped the charges later.

4. Aggressive Accounting Assumptions - Inconsistency in Effective Tax Rate & Cash Tax Rate -

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017

Tax Rate (Tax/PBT)	34.3%	32.9%	7.2%	25.5%	27.9%	31.1%	27.4%	37.9%	34.2%	35.0%	35.9%
Cash Tax Rate (Tax Paid/PBT)	3.2%	6.4%	16.6%	4.1%	16.2%	20.0%	18.4%	34.6%	29.1%	48.2%	35.6%

(Multi-Act Calculations)

Till 2013, there appears to be large inconsistency in the profits as per income tax and the reported income, as can be seen from the above table. Major reason for this deviation is 'Deferred Tax Liability (DTL) on account of Difference between Book and Tax Depreciation' due to aggressive assumption for useful lives of assets (almost double the useful life assumed by peers). This had led to higher reported profits for the company till 2013.

In 2014, adoption of depreciation rates as per new Companies Act, 2013, resulted in higher cash tax payments & more aligned cash & statutory tax rates thereafter. Now that company does not have any deferred tax asset/liability on its balance sheet, cash tax & statutory tax rates are expected to remain aligned going forward.

5.Deterioration in M-Score -

M-score is a score indicating possible manipulation of financials (developed by Messod D Beneish Study, Professor, Indiana University). In case of this company, out of the total 19 years, M-score shows possibility of manipulation in 9 years. High Sales growth, volatile debtor turnover & high accruals has kept the M-score in danger zone in 6 of the last 8 years, which might be indicating possibility of aggressive revenue recognition and poor cash flow generation.

Please refer Appendix ¹

Conclusion:

This exercise reaffirmed our strong belief that an in-depth assessment of a company's quality of earnings is indispensable before using the reported numbers and filings for valuation & investment decisions.

In May, 2017, we had covered the subject company for one of our client & had highlighted all the above points as Key Highlights. The said client found it interesting and concurred with the

issues/red flags raised by us on the quality of earnings and corporate governance and therefore avoided any investment in the company.

Note: Names of parties/companies have been masked/changed for compliance purpose.

Statutory Details:- Multi-Act Equity Consultancy Private Limited
(SEBI Registered Portfolio Manager – Registration No. INP000002965)

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Notes:

M-Score: In his out of sample tests, Prof. Beneish found that he could correctly identify 76% of manipulators, whilst only incorrectly identifying 17.5% of non-manipulators ↩