The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs" – Warren Buffett. High corporate governance standards and prudent capital allocation are few of the key requisites in Multi-Act investment philosophy. In the below article, we discuss certain quality of earnings and corporate governance issues encountered while working on a company.

1. Working capital management / receivables discounting – Companies often resort to receivables discounting to get early payment and ease the working capital requirement. It is important to analyze the trend in discounting / securitization to understand true working capital requirement.

Company under the discussion had been discounting its receivables. Moreover from 2015 onwards it has disclosed in the Annual report that 'Company has retained the credit risk and continued to recognize the transferred receivables in their entirety in the balance sheet.' I.e. started recording discounted receivables as both receivables and other current liabilities.
Thus one should look at adjusted (for receivables discounted) receivable days and cash conversion cycle to get true picture of working capital. As can be seen below, adjusted receivable days were ~ 2 x the reported receivable days during 2009-14.

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Receivables discounted with the bank	246	645	245	101	949	806	120	172	162	146
As % of revenue	3%	6%	2%	1%	6%	5%	1%	1%	1%	1%
As % of gross receivables (before discounting)	49%	70%	55%	25%	70%	63%	14%	16%	15%	12%
Receivable days	11	9	6	8	9	10	20	21	22	23
Adjusted receivable days	22	30	13	10	30	27	20	21	22	23
Revenue growth	26%	33%	12%	14%	15%	8%	-7%	17%	-7%	14%

2. Excessive leverage – Excessive leverage could act as double edge sword (especially in cyclical business) – it magnifies the returns on the higher side during up cycle and on lower side during downscale. Thus it is important to analyze the debt levels w.r.t D/E, repayment capability, cost of borrowings, use of funds etc.

Company under the discussion has over the years raised debt to fund CAPEX and acquisitions. Over last 2-4 years there has been significant jump in net debt.
Some of the borrowed funds have been diverted towards "Loans to body corporates" in last

few years, resulting in poor D/E ratio and Net Debt/OCF coverage ratio. High interest cost has impacted the profitability.
Calculated Cost of debt is unusually higher (though as per Notes to Accounts interest rate charged is MCLR + 1-2%), similarly average yield on cash + deposits + loans is quite higher. While, adequate disclosures are unavailable explaining this, it could be the case that Debt / ICDs are being under-reported or Debt / ICD levels are higher during the year as compared to year end.

	2013	2014	2015	2016	2017	2018
Total Net Debt	3,019	3,494	6,181	8,422	10,511	11,272
Total Debt / Equity ratio	0.2	0.2	0.3	0.4	0.5	0.5
Net Debt / OCF coverage	1.7	2.0	8.1	7.5	11.7	8.8
Interest expense as % of sales	3.1%	3.4%	4.4%	5.8%	7.6%	8.9%
Interest coverage ratio (EBITDA / Interest)	7.5	5.9	2.0	1.6	0.3	0.8
Avg. cost of debt	19.9%	21.6%	15.9%	15.3%	15.3%	17.8%
Yield on deposits + cash+ loans	8.5%	11.3%	13.0%	16.6%	20.7%	17.1%

3. Loans to body corporates: A corporate governance issue –

Company has given certain loans to other body corporates. These body corporates are not disclosed under related party transactions.
In last 3-4 years there is significant increase in net debt and at the same time there is increase in these loans in absolute terms as well as % of Net worth and Net debt, indicating that borrowed funds were diverted to give loans rather than for business operations.
Calculated interest yield on loans is too high indicating poor credit rating of the borrower and actual loans given during the year might be much higher than the closing balance.

	2011	2012	2013	2014	2015	2016	2017	2018
Loans to Body corporates					Loan to others <<			
Current	259	87	67	58	436	2,207	2,840	6,456
Non-current	-	-	-	-	85	85	110	110
Less: allowance for doubtful debts	(25)	(25)	(25)	(25)	(25)	(25)	(110)	(110)
Total	**234**	**62**	**42**	**33**	**496**	**2,267**	**2,840**	**6,456**
As % of networth	1.6%	0.4%	0.2%	0.2%	2.4%	10.9%	14.5%	29.8%
As % of net debt	5.6%	1.7%	1.4%	0.9%	8.0%	26.9%	27.0%	57.3%
Net Debt	4,201	3,664	3,019	3,494	6,181	8,422	10,511	11,272
Total Interest income	99	236	209	302	370	709	988	1,421
Yield on loans			39.5%	50.4%	48.0%	26.8%	30.4%	20.3%
Yield on deposits + cash			5.0%	7.1%	4.9%	4.6%	2.7%	3.7%
Yield on deposits + cash+ loans			8.5%	11.3%	13.0%	16.6%	20.7%	17.1%

4. Increase in pledged shares: A corporate governance issue – Increasing leverage, high pledge shares, rating downgrades – all indicate poor corporate governance and poor fundamentals.

	2012	2013	2014	2015	2016	2017	2018	2019
Pledged shares as % of promoters holding	11.7%	11.7%	11.7%	11.7%	22.1%	23.9%	35.2%	38.0%
Pledged shares as % of total shares outstanding	5.4%	5.4%	5.4%	5.4%	11.0%	11.9%	14.3%	16.2%

While investors have been focusing on growth and thus indirectly on the income statement, analyzing the balance strength and promoter intent / corporate governance is of equal importance.

In the above case, all of the issues were clearly visible from thorough assessment of publicly available information, all one needs to do is deep dive into the information to assess the quality of earnings and corporate governance.

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