Quality of Earnings

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 aspects 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 shareholder's 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 has 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 the company 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.

In 2018, company's share price plunged more than 70% in a day causing a permanent loss of capital for shareholders.

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 because 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 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.

Sales breakup	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
China	n/a	n/a	n/a	n/a	n/a	2%	4%	n/a	n/a	n/a	n/a	17%	19%	29%	**50%**
Taiwan	n/a	n/a	n/a	n/a	n/a	n/a	n/a	11%	16%	20%	**32%**	**30%**	**55%**	**61%**	40%
Singapore	**75%**	**57%**	33%	31%	19%	18%	18%	**26%**	**24%**	**20%**	20%	12%	7%	4%	3%
Malaysia	23%	35%	**42%**	**42%**	25%	20%	15%	14%	10%	8%	7%	n/a	n/a	n/a	n/a
Indonesia	n/a	n/a	24%	23%	**45%**	**46%**	**30%**	12%	15%	10%	10%	4%	6%	3%	2%
Thailand	n/a	n/a	n/a	n/a	n/a	2%	13%	19%	19%	10%	8%	n/a	n/a	n/a	n/a
Philippines	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	6%	25%	3%	n/a	n/a
Korea	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	17%	3%	n/a	n/a	n/a	n/a
Others	2%	8%	2%	4%	10%	11%	19%	18%	16%	15%	14%	12%	9%	4%	4%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Growth	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
China	n/a	n/a	n/a	n/a	n/a	n/a	41%	n/a	n/a	n/a	n/a	n/a	52%	193%	91%
Taiwan	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	15%	48%	38%	72%	148%	118%	-28%
Singapore	31%	38%	1%	34%	-18%	-12%	-24%	-5%	-20%	-6%	-14%	9%	-16%	-5%	9%
Malaysia	141%	176%	115%	41%	-20%	-26%	-42%	-38%	-38%	-14%	-22%	n/a	n/a	n/a	n/a
Indonesia	n/a	n/a	n/a	35%	162%	-4%	-51%	-73%	6%	-20%	-14%	-31%	125%	-16%	-2%
Thailand	n/a	n/a	n/a	n/a	n/a	n/a	346%	-2%	-17%	-37%	-32%	n/a	n/a	n/a	n/a
Philippines	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	610%	-85%	n/a	n/a
Korea	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-88%	n/a	n/a	n/a	n/a
Others	156%	709%	-54%	168%	236%	2%	31%	-36%	-26%	8%	-21%	65%	-7%	-15%	27%
Total	**48%**	**81%**	**78%**	**40%**	**33%**	**-6%**	**-24%**	**-32%**	**-16%**	**16%**	**-15%**	**83%**	**35%**	**97%**	**10%**

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) High Royalty rates charged by a global FMCG to its Indonesian Subsidiary

Parent companies often charge royalty fees to their subsidiaries for using parent's trademark and brand. By increasing royalty rates, parent companies can increase their share in total profits at the expense of minority shareholders.

A global FMCG was charging ~3.5% royalty to its Indonesian subsidiary till 2012, however in Dec 2012, when they renewed the agreement, total fees payable to parent were doubled.

Fees to Parent	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
As a % of Revenue	3.6%	3.3%	3.4%	3.3%	3.2%	3.4%	**4.5%**	**5.6%**	**7.0%**	**6.9%**

Royalty rates charged by the parent to its other subsidiaries listed in India, Pakistan and Nigeria are 3.2%, 3.1% and 2.5%. The parent is charging highest royalty to its Indonesian subsidiary. The change in royalty rates in 2012 in for Indonesia also indicates a risk that, in future the parent may elevate royalty rates of other subsidiaries.

3) 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.

4) Improvement in margins of a company operating retail stores in India.

It seemed that gross/operating margins for the company had improved over a period. However, deeper analysis of financials revealed that the improvement was mainly due to change in accounting of a subsidiary.

Company's loss-making grocery business was accounted as a subsidiary till 2014 thus 100% of revenues and operating expenses were consolidated on a line-by-line basis. In 2015 that business got converted from a subsidiary into Joint Venture and thus was accounted using proportionate consolidation method. Proportionate consolidation reduced the share of losses accounted by the company.

Further, in 2017 on transition to Ind AS, Company started accounting that subsidiary using equity method that is recording only the share of net losses as a single line item. This led to further improvement in gross and operating margins.

In this company margin analysis without cognizance of impact of accounting changes could result in misleading conclusions.

We also observed that on cumulative basis around 76% of the company's profits were from Investment income. High dependence on non-core earnings is a poor sign. Additionally, existence of high debt as well as investments on Balance Sheet raises questions on capital allocation.

How you could benefit from our Investment Research Service

We believe our services will be value-additive to fund managers, in local or discrete geographies who are looking for Financial Statement Analysis and Quality of Earnings analysis as a part of their investing process.

This analysis is an integral part of our own investment process. Besides us, a few other FIIs and hedge funds are using this service. We have by now covered companies across the globe, namely in markets like North America, Europe, Japan, Hong Kong, Singapore, Korea, Taiwan, and India.