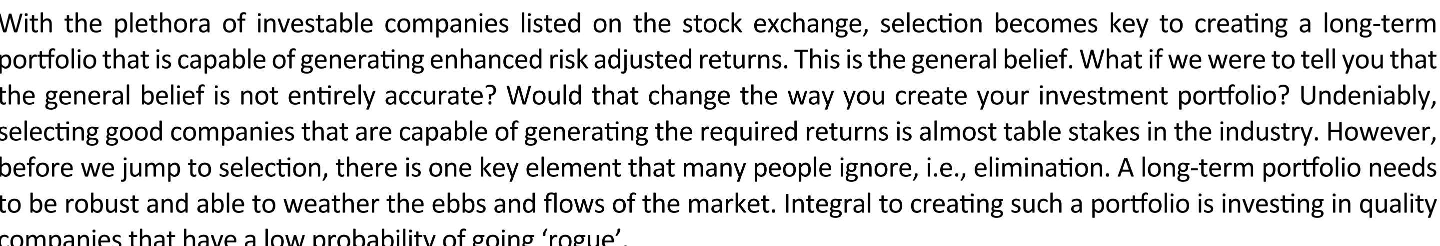
THE SCANNER

The **'why'** and **'how'** of identifying rogue companies



With the plethora of investable companies listed on the stock exchange, selection becomes key to creating a long-term portfolio that is capable of generating enhanced risk adjusted returns. This is the general belief. What if we were to tell you that the general belief is not entirely accurate? Would that change the way you create your investment portfolio? Undeniably, selecting good companies that are capable of generating the required returns is almost table stakes in the industry. However, before we jump to selection, there is one key element that many people ignore, i.e., elimination. A long-term portfolio needs to be robust and able to weather the ebbs and flows of the market. Integral to creating such a portfolio is investing in quality companies that have a low probability of going 'rogue'.

The fact of the matter is that the investment universe is peppered with rogue companies that inadvertently find their way into investor portfolios and have a disproportionate impact on overall portfolio returns. Take for example an Indian company engaged in the medical equipment business. The company's 12-year average Return on Equity (RoE) and Return on Capital Employed (RoCE) was 33% and 23%, respectively. As a result, the company was perceived as a compelling investment option by many managers on the street and was in fact, a part of at least 20 mutual fund portfolios in the period 2005-2012.

However, our analysis of the company's financials revealed that the earnings may not be reliable. During the 2005-2012 period, the M-Score (one of the many factors in our analysis) of the company indicated high risk in all the years, mainly due to high accruals and high inorganic and organic sales growth. This was reflected in poor free cash flow (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.

During this period, most market participants chose to ignore the negative cash flows and instead focused on the company's prevailing growth numbers and future potential. Subsequently, the debt on the company's balance sheet kept piling and its dependence on capital markets for growth and survival increased manifold. Due to limited tangible assets, most market participants valued the company based on its earnings potential (as is the case for companies in that industry). However, a deeper analysis of reported fundamentals would have revealed that those earnings were suspect and needed further investigation.

Our analysis also suggested that the company had adopted debatable accounting practices like capitalising R&D expenses, channel stuffing, and routing transactions through net worth directly. Some questionable accounting treatment of goodwill on consolidation of subsidiaries in FY 2012 further accentuated the risk pertaining to **Quality of Earnings (QoE)**. The market eventually recognised issues with the company, resulting in a more than 90% correction in stock price and significant erosion in portfolio value. This is what we would call a classic rogue company. The above example underscores the need to proactively identify rogue companies and eliminate them in the initial stock filtration process.

Multi-Act has developed a systematic approach for assessing the QoE. The main goal of this system 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. It has consistently served as a good tool to identify rogue companies and can be used by investors to eliminate the rogue companies before implementing their custom selection criteria.

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MA QoE system in action: Performance of best and worst QoE quartiles

	Q1 (Best)	Q4 (Worst)	Index (NSE 500)
CAGR (Oct 2004 - Jul 2023)	**14.1%**	**8.5%**	**11.5%**
Maximum Drawdown	-53.8%	-76.4%	-62.7%
Median Drawdown	-6.2%	-37.8%	-8.2%
Risk Adjusted Return*	2.28	0.22	1.42

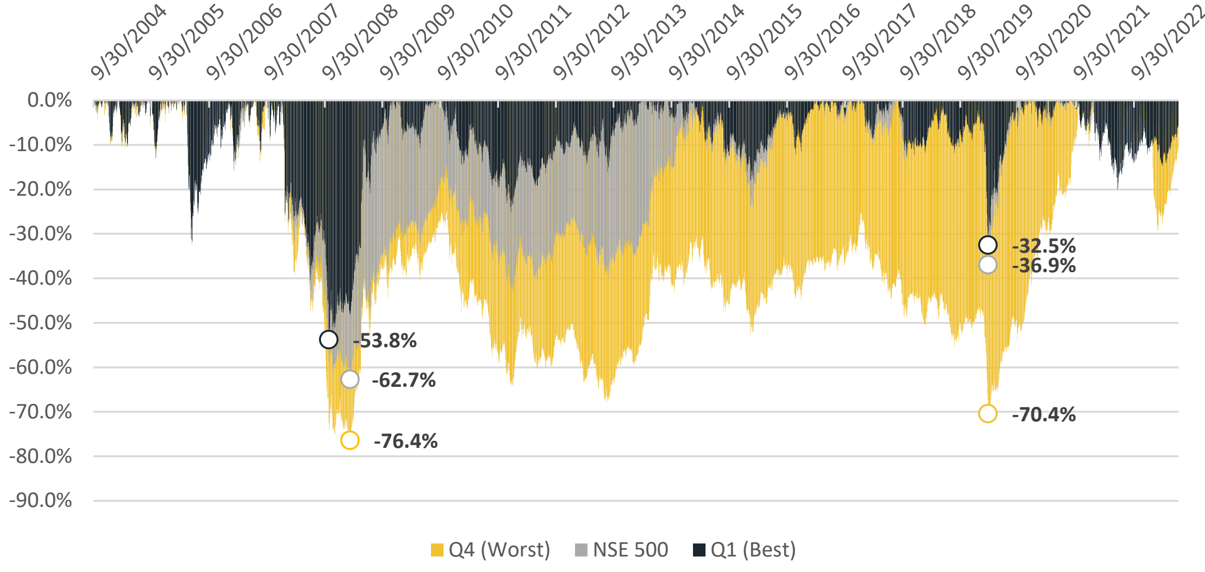
Alpha	
Q1 - Q4	Q1 - Index
5.6%	2.5%

*Calculated as LT CAGR divided by median drawdown for same period

Relative Performance

14,000
12,000
10,000
8,000
6,000
4,000
2,000
0
9/30/2004 9/30/2005 9/30/2006 9/30/2007 9/30/2008 9/30/2009 9/30/2010 9/30/2011 9/30/2012 9/30/2013 9/30/2014 9/30/2015 9/30/2016 9/30/2017 9/30/2018 9/30/2019 9/30/2020 9/30/2021 9/30/2022
11,981
7,802
4,593
Quartile 1 (Best) Quartile 4 (Worst) NSE 500

Drawdowns



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Q&A

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In your opinion, what are rogue companies?

Rogue companies are primarily those companies that have poor QoE. While there are myriad ways to assess a company's quality of earnings, below are a few common indicators that can help you identify rogue companies.

- **Poor corporate governance:** Engaging in accounting manipulations, excessive related party transactions, complex company structures, etc.
- **Poor fundamentals**: Lack of / low operating cash flow generation, continued poor returns, high leverage, etc.
- **Aggressive capital allocation**: Frequent acquisitions at high valuations, aggressive capacity expansion, venturing into unrelated business segments, etc.

Why is it critical to assess the probability of a company going rogue?

Investing in rogue companies can lead to 100% capital erosion. Take the example of Gitanjali Gems which fell from a price of ~Rs. 600 in June 2013 to ~Rs. 224 by 1st July of the same year and then to Rs. 73 by the end of July. Today, the stock trades at Re. 1. The sharp decline was in response to the market recognising the issues that had already been brewing in the company and accordingly assigning it a steep discount to even its net-net value.

It shows us that if the QoE is poor, no amount of margin of safety is sufficient to protect you from permanent loss of capital. If you conclude that a company is of poor quality, it is prudent to stay away from that company, no matter how attractive the stock price or valuation appears to be. Any number, no matter how high, when multiplied by zero results in a zero. It is important to identify such landmines in advance and avoid them in your portfolio.

Let's look at two hypothetical portfolios. Both portfolios have two common companies and one unique company. Company C's stock price is growing slowly at a 10% pa. Whereas Company D grew at 30% initially but in Year 2, lost 90% of its value. And that resulted in significant underperformance of Portfolio B against Portfolio A.

Portfolio A	Year 0	Year 1	Year 2	Year 3	Year 4	CAGR
Company A	33.0	38.0	43.6	50.2	57.7	15.0%
Company B	33.0	39.6	47.5	57.0	68.4	20.0%
Company C	33.0	36.3	39.9	43.9	48.3	10.0%
Total Portfolio	99.0	113.9	131.1	151.1	174.5	15.2%
Growth		15%	15%	15%	15%	

Portfolio B	Year 0	Year 1	Year 2	Year 3	Year 4	CAGR
Company A	33.0	38.0	43.6	50.2	57.7	15.0%
Company B	33.0	39.6	47.5	57.0	68.4	20.0%
Company D	33.0	42.9	4.3	4.7	5.2	-37.0%
Total Portfolio	99.0	120.5	95.5	111.9	131.3	7.3%
Growth		22%	-21%	17%	17%	

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What are the 4 major red flags that investors need to look out for?

- Aggressive or questionable accounting practices
- High accruals i.e. earnings not supported by operating cashflows
- Heavy reliance on capital markets (debt or equity) for day to day operations or expansion
- High leverage

What is the Multi-Act way of identifying potentially rogue companies?

Over the last two decades, we have studied the annual reports of more than 1,000 companies. Based on our cumulative experience we have developed expertise in evaluating QoE. Comprehensive checklists have been established to proactively identify red flags in companies. Our analysts have been trained to dissect the earnings in a focused, process oriented, and methodological way. We supplement our QoE analysis with independent statistical scores like M-Score, F Score, and AZS Score. Further, we have automated screening for the most common red-flags and have also developed a proprietary QoE Score to evaluate the earnings quality of a large number of companies on an automated basis. Our multi-layered process of QoE analysis aids in keeping any behavioural biases in check.

Any specific strategies that you would recommend for proofing your portfolio from rogue companies?

While screening companies:

- Understand the accounting policies employed by the company vis-a-vis GAAP and global peers
- Evaluate if reported financials reflect the true economic earnings of the business
- Understand sources of revenue growth and net profits to determine sustainability of growth and earnings
- Assess the balance sheet to determine financial strength and liquidity risk
- Analyse corporate governance actions 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.
- Assess capital allocation decisions especially with respect to Mergers & Acquisitions (M&A) and buy back of shares to determine if management decisions have created value for shareholders over the long term

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