Governance Checks - The art of not being a fool

"A fool and his money are soon parted"

Holds true in investing too, how not to be such a fool is a very important part of investing.

Forensic analysis, channel checks, corporate governance evaluation, corporate structure & analysis of related parties are some facets that one needs to focus on to minimize the possibility of someone playing you for a fool. There is nothing more infuriating or frustrating than to be taken for a ride, especially as a minority equity investor who has no say in most things about the underlying business.

It is qualitative, back breaking work that is not sexy. Yet, this is what gives you the conviction to bet big when you see undervaluation. Without doing this leg work, you will at most make some money when you see an interesting story, you are unlikely to create wealth.

When you do the work, you also have the comfort that the story is unlikely to sink your capital. Unless you have lost 80%+ of your principal in an investment, you will not understand the importance of this aspect.

Frameworks and checklists work very well in doing qualitative due diligence on a business. They ensure that you cover all bases and consider the perspectives that are worth considering. This does not ensure you make good returns from an investment, but it does minimize the possibility of losing a chunk of your principal on any investment over the medium term.

Rule 1: Never lose money

Rule 2: Never forget rule 1

This is a quote attributed to Buffett himself. By now you should get the drift of how important this is.

As is always the case, the focus of any publication here is on tangible takeaways that can improve the odds of investing outcomes. What follows next is a broad summary of what I do to minimize the possibility of me being a fool, what works for me should work for you too.

Business Related Checks

- **Is the company doing things that are drastically different from competition?**

  Are all other competitors going after the economy segment while the particular business is going after the small but niche premium segment? If so, what is unique about the company's product portfolio, distribution, pricing and positioning?

  If the entire industry works on the franchise model for stores and this company chooses to open company owned stores, what could be the possible reasons?

  If the sector does not see M&A activity frequently while one single company keeps acquiring/divesting assets every 2 years, what are the reasons for this?

An investor should be able to find convincing reasons for why this difference exists while thinking independently. Managements will always have some or the other answer ready for why the difference exists. Trust but verify should be the approach of the prudent investor.

- **In a business of this nature, what is the easiest way to siphon off money?**

  Ghost capex that somehow never yields much (monitor gross asset turns)

  Inflated revenue for some quarters followed by a one-time write-off of AR

  High R&D spends with little to show in terms of outcome

  Below average operating cash flow, higher profits never trickle down into the cash flow

  Chor promoters want high valuation as well as higher cash flows into their personal pockets while leaving minority investors high and dry. The usual routine is to show higher revenue and higher accounting profits to keep valuation high while the actual cash gets lent out/invested for their personal objectives.

- **History of frauds in the particular sector**

  Some sectors are more prone to frauds due to the very nature of the business. It is much easier to pull off fraud in a financial business than in a brick-and-mortar business. It is also much easier to employ creative accounting methods in a business that has intangible assets than in a business that needs tangible assets. Periodic M&A activity offers the possibility of further confusing investors through complex structuring, it also serves in ensuring investors never have a consistent basis for judging how the balance sheet changes over time.

- **Unit Economics – Do the numbers fit into the normal range for this category?**

  If the entire industry works at 16% EBITDA margin while a lone company claims 25% EBITDA margin, probe deeper.

  Within a given industry, factors like credit period to the channel, credit offered by vendors, employee expenses, asset turnover all stay within the same range unless the technology/business model is drastically different. Always consider the unit economics at a fundamental level before looking at ratios.

Always understand the industry well first, benchmark all the players before getting into the specifics of a particular business. Most businesses would be clustered around the average for that industry on unit economics, outliers always demand a deeper look before taking their numbers at face value.

Base rates exist for a reason, the outside view should be the starting point.

Accounting Checks

- **Is accounting simple or complicated for this business?**

  Businesses that deal in intangibles have more flexibility in accounting. The useful life time of a car or a crane can be estimated, doing the same for IP or goodwill is not that easy.

Businesses that execute projects for specific customers can use the POC (percentage of completion method) to book revenue. A business that changes its accounting policy can see a sudden spike in revenue and profits.

Within the same industry vertical of financialization, asset management companies have very simple accounting while life insurers have very complicated accounting. Sometimes revenue is booked over years while costs are booked upfront.

I have given some good businesses a pass because accounting was not simple, this gives management a lot of leeway in dressing up numbers if they wanted to.

- **Bad debt, Provisions and other write downs**

A lack of understanding of how a lender classifies and provisions for NPA's can sink investors. Anyone who got canned in the PSU banks investing theme post 2011 knows exactly what this is all about. I was one of the few tech salesmen who was at the forefront of this RBI initiative, selling core banking modules that were to automate NPA classification and provisioning.

How can one customer be an NPA for Bank 1 but be a good customer for Bank 2?

How do you recognize if loans are being evergreened by a bank? If a customer owes the bank 500 Cr but is unable to pay up, a bank can pass accounting entries to show as if the 500 Cr was paid back and lent out again.

My notes from a micro-cap I had recently analysed – "*Bad Debt provisioning has been very high in 2019 and 2020, most likely cleansing of old sins by the new management. The numbers declared on the financial statements cannot be fully trusted, especially given the large delta change post transition to IND AS*". The stated asset values of this business on the balance sheet went up 1.5x after the transition to Ind AS in 2018. The same individual has been signing off on the company financial as the external auditor since 2011, of course from different companies.

- **Consistency in Taxes in P&L and Cash Flow**

When you inflate revenue and profits, you make a provision for higher taxes in the P&L. But if that tax never gets paid to the authorities, there is a good possibility that the numbers are bogus. Remember the maxim – show higher profits to keep valuation high but keep cash payout to authorities and investors minimal? This is how some chor promoters operate.

- **Drill down into each large item in the Balance Sheet including Contingent liabilities**

Check the ageing structure of the AR, see what % of that is being written off as bad debt under other expenses.

What is the nature of the contingent liabilities? Any litigations that the company is under?

What % of the finished goods inventory has the company been holding for > 2 years in the case of a consumer company?

How much is due from related parties? Is this balance increasing or decreasing over the years?

Promoter Actions and Capital Raising

- **Any unnecessary being adventures undertaken by the promoters?**

  Does the promoter make investments into unrelated areas? Either through the company or through his personal funds? Some promoters appear to be more interested in investing into the next Flipkart rather than running their core business well, tells you a lot about what they feel about their own business.

  What percentage of the promoter holding is pledged? Is this for reasons related to the business or is it for other reasons? In general, I do not like to see promoter holding being pledged.

  The business being evaluated accounts for what % of the promoter net worth? If the promoter has a net worth of 5,000 Cr while the market cap of the current business is 300 Cr, do you really think he will be focusing all of his energies here?

- **What other organizations are the promoters associated with?**

  It is not out of place to see some promoters being directors on a few real estate holding and construction entities. These would most probably be land banks that they acquired over a period of time and are now monetizing. But if a promoter is associated with too many unrelated companies, it is time to drill deeper and understand why.

  Birds of the same feather flock together. What is the nature of the others individuals who are directors in these companies? Key work search for each of the directors and companies can reveal some surprising insights.

- **Any inconsistencies in fund raising and subsequent actions?**

  Some promoters raise funds and then do nothing with them for years together. Why raise funds when you do not have a specific purpose with a specific timeline?

  Good promoters are wary of diluting stake. Any business that keeps diluting equity every 3 years (unless they are in the business of lending money) poses questions about both the intent of the promoter and the quality of the business. Compounding effects rarely play out in such businesses, especially those of the positive kind.

  A listed lifestyle and health business dip a QIP and sat on 200+ Cr cash for more than 3 years. One fine day they went out an opened 20 centres in the same city! Over the next few months, they went out and acquired a chain outside India, when their annual report said India is a largely underpenetrated and unorganized business for their market.

- **Any over the top management speak in the media?**

  Good listed companies try to under promise but overdeliver, they understand that managing expectations is very important to the investing community. When managements come out and start making over the top statements and lofty projections that will be tough to execute, it is a matter of time before investors get wary of them.

  Some businesses suffer from a "valuation discount" due to this, most managements learn from their mistakes. But if the same trend continues over a period of time with a stock price that fluctuates wildly following announcements, you may well be looking at an operator driven story.

Governance Framework

- **What are the related parties? What is nature of engagement with them?**

  Good promoters do not have other businesses that compete with their listed business. At best they might have a few entities which act as marketing/distribution agents in an effort to transfer some risk away from the listed business. Especially when the law of the customer land is different. But if you see the promoter's nephew/relative running a similar business, it cannot be a positive in any sense.

  What is the nature of financial transactions between the entities? It is just a leasing/distribution/rent agreement executed on market terms, or is the promoter family using it to benefit at the minority shareholder's expense? If a related party owns a property which is leased to the CEO of the company, where the rent/lease amount is 2x the market rate, you should see this as a sign that the promoter views other shareholders only as a necessary evil.

- **How many subsidiaries does the company have? What is the stake in them?**

  A large listed NBFC has more than 100 subsidiaries with complex interlinkages. There are corporate guarantees, inter corporate deposits and lending arrangements. One of its smaller listed peers has just 18 subsidiaries and the objective of each one of them is very clear. There are minimal interdependencies across these entities.

  It is not just about whether the promoter is creative right now, it is also about the leeway they have given themselves to get creative if and when they want to.

- **What is the promoter remuneration? Do the board members get just a sitting fee or a commission too?**

  Some board members also advise the management and play a role operationally, them getting an incentive for bringing in their wisdom and network to the table is acceptable.

  What is not acceptable is for an independent board member to get a sitting fee of INR 20 lakh for attending 4 board meetings a year.

- **What is the auditor remuneration? What has been the trend?**

  Does the auditor get paid a fair fee or do they appear to be getting a fee to overlook a few things? I have seen a Hyderabad based financial technology company (I still cannot comprehend what they do) spike their auditor fee from 2 lakh to 25 lakhs within 2 years.

  What other customers does the particular auditor serve? Do they have any reputation at stake or are they just yes men willing to sign off on anything for a fee?

- **What is the constitution of the board? Are there enough members who have reputations outside of the business at stake?**

If the promoter family is leagues above the independent board members in terms of social status and stature, I see it as a possible red flag. It indicates promoters who want to live in an echo chamber and surround themselves with yes men.

Good promoters understand that the quality of the board is a signalling mechanism to the investor community. When independent board members have reputations at stake, they will not hesitate to cut their losses and move on if they sense something is amiss.

This is not a failsafe given the frauds that have happened but this is a good safeguard more often than not. Inferential reasoning helps in this sense, asking why things could be the way they are can provide insights.

Summary

Once again, this is not a comprehensive exercise by itself. My corporate governance checklist has more line items than those listed above. I also triangulate the insights from credit rating reports and see if the story adds up before coming to any conclusions.

Governance checks call for the investor to think like a detective, any possible loose end has to be investigated thoroughly before coming to any conclusions. This is not the domain of black and white thinking; it is a qualitative domain where one can never be certain of the situation. Investors with some amount of worldly experience and wisdom are likely to do better than a 25-year-old Ivy league graduate.

None of this can rule out accounting errors/frauds totally but it does reduce the possibility of you getting caught in a story that had some obvious red flags to begin with.

Do whatever it takes to not be a fool in investing.

Do the work, don't just go around quoting Buffett to impress people.

Saying is not the same as doing.

Anyone can read a book and quote from it.

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The purpose of this publication is not to express views on the valuation of the business, or the sector being discussed. Most of the content here is an exercise in inferential reasoning and the mental models involved in

thinking about businesses in general. Effective learning calls for specific examples to drive home the core concepts and that precisely is the endeavour here.

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