How to Identify Fraudulent and Fragile Companies

Who knew that the liquidity crunch which began in September 2018 would kick start one of the most sweeping clean-ups in Indian corporate history?

Slowly, all cockroaches are coming out one after the other. Fraudulent business, over-leveraged or fragile, the sudden drying up of liquidity has now exposed them all. Stocks of these businesses have crashed as much as 70-80 percent in the last year and this fall has surely shaken investor confidence.

Many new investors are learning the same old lessons. Unfortunately, many are still committing the same old mistake of averaging costs when stocks are falling heavily.

Some think that these stocks have fallen 80 percent from their 52-week high, and so, how much more can they fall? They do not realize that these shares could fall another 100 percent from here before they become zero in value. When you realize you are in a hole, the first thing to do is to stop digging further.

So, the idea of recovering losses by averaging down the very same stocks may not be wise.

One sensible question which many individual investors are now raising is whether it's possible to identify such fraudulent or fragile companies? If yes, what are the factors to consider?

Here, I share some key factors using which even a layman can weed out 90 percent of such fraudulent and fragile companies and minimize the chance of permanent loss of capital by filtering out such businesses while investing.

Debt

The single biggest reason for corporate bankruptcy is borrowed money. Nobody can force you into bankruptcy if you don't owe them any money. Unnecessary Capex or an ill-timed acquisition can still be managed if funded with internal accruals.

However, the effect of that wrong decision gets magnified if it's funded with debt.

Look at all the troubled companies and most of them would have one thing in common – debt. This applies not only at the company level but also at the parent company's and promoter's levels.

The recent Zee Entertainment & Dish TV fiasco is a classic example; though these companies hardly have any debt, the Essel group (promoter) is over-leveraged and has pledged its shares in Zee & Dish. The stock prices of the two companies crashed.

Long Working Capital Cycle

It is the capital that's blocked in inventory (raw material & finished goods) and receivables (debtors). A shorter cycle indicates a high-quality business and its ability to convert goods into cash quickly.

Some of it is funded by the credit period offered by raw material suppliers (payables/creditors). However, you should still focus on gross WC days (inventory + receivables) rather than net WC days, which subtracts the creditor days.

This is because troubled companies often delay vendor payments by offering higher rates and hence the net WC days could mask the trouble.

The lesson here is that shorter the gross WC cycle, the better it is. High-quality businesses such as those from the FMCG segment enjoy negative working capital. A long working capital cycle is a big constraint to growth and leads to negative operating cash flows, which can necessitate debt to fund operations.

Negative Operating Cash Flows

A business may have negative operating cash flows for a year or two due to changes in working capital. However, one should see this in periodic batches of say three or five years.

If it's negative consistently, there is bound to be some issue with the business. Sales could be fudged and inventory or debtors could be overstated.

Investors often focus on Profit & Loss statement and ignore cash flows; however, that's where the real underlying issues can be identified.

Low Promoter Holding or High Pledging

A high promoter holding (maximum allowed is 75 percent; proposed to be changed to 65 percent in the 2019 budget) ensures that the promoter has enough skin in the game and low incentive to benefit at the cost of minority shareholders.

This is especially true for small owner-operated companies.

Similarly, it could mean trouble if the promoter's shareholding is pledged, as even if the share price drops due to general market volatility, he/she could get a margin call which if he/she fails to honor, could result in a steep fall in share prices triggered by the selling initiated by the lender, without any change in fundamentals.

Related Party Transactions

Multiple promoter entities in the same industry having significant transactions with listed entities is generally a red flag. Similarly, corporate guarantee given for a promoter's private entities is another risk.

Partly owned subsidiaries with the remaining stake held directly by promoters generally show greediness and mala fide intentions on the part of promoters.

A clean corporate structure with all business being done through one single listed entity is the most desirable form.

Frequent Equity Dilutions/Stake Sale

A promoter who keeps raising capital by equity dilution or selling down his stake is generally a red flag and indicates that he himself doesn't value equity.

Pays No or Low Tax and Dividend

If a company pays no tax or much lower amounts compared to the prescribed rate of 33 percent even when peers pay full tax, you should become alert and find out the reasons.

Promoters who show fictitious profits generally find ways to avoid taxes because that would mean an actual cash outflow on profits which the company never made.

Do not rely solely on tax figures stated in the P&L statement. Check the actual tax outflow from the cash flow statement.

Similarly, such entities generally avoid paying out any dividends as it again involves an actual cash outflow from profits that were never made.

Cycle Average RoCE < 12 Percent

Return on capital employed (RoCE) is the return (operating profit) a business generates on the total capital employed (equity + debt).

If across a complete cycle (typically 6-7 years), the return is lower than the cost of capital (12 percent), the business is destroying value and until something material changes in the business strategy/industry, the shareholders are unlikely to make money from such ventures.

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