- Investing in companies with wide economic moat during their early stage can generate a multibagger return.
- Companies can create economic moat by offering better products/service or utilising their brand strength or locking customers from competitors.
- Increasing ROE over the last 5-10 years with improved operating margin and cash flow is a prominent signal of economic moat.
- It is highly recommended to avoid high debt companies. Avoid stocks having debt to equity ratio more than 1 (increasing) and ROE less than 12% (decreasing over the last few years).
- Higher debt translates into higher interest outgo that eventually minimises profits and erodes shareholders value.

Chapter – 4
How to Evaluate Management?

4.1 Difficulties in Evaluating Management Quality

During my teenage years, I had read many bestselling books on the stock market. From those books, I got a clear message that it is very important to judge management quality before investing in any stocks. We all know that good management can turn around a poor business while poor management can ruin the quality business. Now the big question comes, “How to judge whether the management is good or bad?” Frankly speaking, not a single bestselling books solved my query. Many of those books coined the idea of management visit, discussion with founders, factory/plant visit, etc. Now, tell me is it possible for any retail investors to visit the management/factory?

Suppose you have twenty different stocks in your portfolio. Those 20 companies

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are headquartered in the eight different cities. Before investing, is it possible for you to visit all those cities to meet the management? I am sure, for millions of small investors, it is next to impossible to meet the management before investing in any companies. Coming back to the analyst's meeting with the management, I have serious doubt in this front too. Suppose, you are holding the position of CEO for a company, and I am the senior research analyst of a reputed brokerage house. During our meeting, will you confess any drawbacks of your business? Your primary target will remain to please me so that I can compose good research report, and thus boosting the stock price. After all, being the CEO, you will be benefitted the most from the rising stock price. So, it is obvious that management will always try to showcase the rosy picture in front of equity research analysts; this is the simple reason behind my doubt on management visit. On the other hand, attending Annual General Meeting (AGM) is far more fruitful because you are not alone in AGM. There are huge numbers of investors and the entire management team to answer queries. Further attending conference call is more beneficial than company visit. After result announcement, most of the companies conduct conference call where various analysts can interact with the management directly. Different types of questions from various analysts and answer from management offer a clear picture.

At the same time, I understand that attending every AGM is not possible for any retail investors. Millions of small investors are there in small towns, far away from metropolitan cities. Moreover, maximum retail investors are engaged in some different job/business. Where is the time for attending every meeting? If you are one among them then I have solutions for you!

4.2 Easiest Methods for Management Evaluation

I am going to present the simplest way for getting an idea about the management credibility. From the comfort of your home, you can evaluate those simple and easy-to-understand methods! Only three inputs are required for our purpose –

1. Shareholding Pattern
2. Dividend History and Tax Rate
3. Return on Equity (ROE)

First of all, let's have a look at the ease of availability of those data. With the advent of the Internet, such data are no longer far away from retail investors.

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Every listed company submit their shareholding pattern to the respective stock exchange. It is mandatory for all companies to disclose shareholding pattern at the end of every quarter. So you can find shareholding pattern for any listed company from BSE website (www.bseindia.com). Promoters or institutional investors purchase stocks via “block deal” or “bulk deal” from the open market. It is also mandatory to disclose such deals. So at the end of the trading day, you can easily access similar data from the exchange website. Return on Equity (ROE) and the tax rate both are readily available from the financials of the company. For ROE, it requires basic calculation. However calculated ROE is readily available on few financial website (make sure to verify it). Dividend history is also readily available on BSE or NSE website. You can access the last ten years dividend history through a single click.

So, all those parameters for evaluating the management are readily available in our hand. You just need an internet connection, that’s it! Now, starting from shareholding pattern analysis, let’s describe all those parameters one by one -

4.3 Management Evaluation #1 - Shareholding Pattern Analysis

Nobody knows the company better than its owners. Detailed analysis of shareholding pattern throws enough light on the future business prospects. Purchasing a stock is nothing but to become a partial owner of the business. As a partial owner, you need to consider the other investors in that business.

Broadly shareholding pattern is divided among two groups -

1. **Promoters and Promoter Group-** Promoters are those who incorporated the company. They can be either domestic or foreign entity (or group of individuals). Relatives of promoters owning shares also come under promoter group.
2. **Public Group-** Shareholders other than promoters constitute Public shareholding pattern. FIIs, DIIs, banks, money managers, mutual funds, insurance companies, individuals, etc. come under this group.

Companies or individuals other than the promoters holding more than 1% of the total share capital need to disclose their details. Let’s have a look at the consequences of company’s performance based on the actions of the

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shareholders. **Remember, the shareholding pattern in isolation is not sufficient enough for taking any investment decision.**

Promoters increasing their stake –

Consider yourself as a promoter of a listed company. Without high conviction you won't purchase the shares of your own company from the open market. So, promoters increasing stake via open market purchase is a positive signal. During 2013, I had invested in a micro-cap stock, Fluidomat based on the similar theme. Throughout the year 2012, 2013 and 2014, promoters were consistently increasing the stake via open market purchase, i.e. purchase from retail investors. The company manufactures fluid coupling that has wide application in the infrastructure sector. Being a small sized company, there was not enough information in the public domain. There were no management interviews/guidance; no conferences call; no public appearance. Further, not a single brokerage or research house had active coverage on Fluidomat. Institutional shareholding was NIL. Investing in such unknown micro-cap always carry a certain amount of risk because you don't have enough information in hand. However, I had invested just because of the single fact that the promoters were consistently increasing their stake over the last few years.

Finally, the strategy paid off, within one year from the investment; the stock generated 300%+ return! There is no harm of holding it as long as the promoters are increasing their stake. Yes, it is risky for investing in unknown microcap stocks; however, in this case, the purchase pattern of promoters minimizes the risk. It feels like; you are not the lone buyer, owners of the company are also buying just like you from the open market. So, just go ahead.

Promoters may increase their stake due to various reasons, but whatever be the reason the result is mostly positive. Let's have a look at few of those reasons –

1. To utilize idle cash efficiently
2. To make the most from lower valuation
3. To acquire greater control of the company

For the retail investor, it is not mandatory to dig dipper on "Why Promoters are increasing their stake?" because whatever be the reason the result would be positive (mostly).

Promoters rarely increase their stake during bull market –

It is very rare to notice that promoters are increasing their stake during bull-

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market. Bear market offers best investment opportunity. It is because most companies opt for acquisitions/buy-back during the economic slowdown. Billionaire Industrialist Mukesh Ambani-led Reliance Industries bought back equity share worth around 39000 million throughout the entire 2012 while the stock price was quoting at near 5-years low. During the peak of 2007-08 bull-run, Reliance was quoted around 1500 level. Since then stock price suffered a lot and gradually fall around 700 during 2012. Exactly half than that was 5 years ago and almost same time Mr. Ambani initiated buy-back. No wonder after such huge buy back the stock price appreciated by 70% over the next 2 years (2013-14). Mr. Ambani didn't hesitate to buy back his own company's share while the stock was quoting near 5 years low.

Increasing promoter holdings either results in price appreciation or downside protection of the stock. If the promoters raise their stake, it is comprehended that they has high confidence in the business.

> *"Increasing promoters holding boost confidence that results into price appreciation or downside protection of the stock."*

Promoters decreasing their stake -

Promoters decreasing their stake can have either positive or negative effect on the stock price. Forced selling by promoters might cause major crash in the stock price. I will discuss the "forced selling" in the latter part of this chapter. Prior to that let's have a look from different angle-

Lower stake of promoters means low confidence in the company i.e. the promoters are not optimistic about the future prospect. Who can forget the Satyam scandal? Total shareholding of promoters and their group was only 10.70%, while the total public shareholding was 89.30% at the end of June 2008. It reduced to 2.70% and total public shareholding tolled to 97.30% at the end of December 2008. Following this share price plunged by 77.7% during January, 2009. In this case, promoters were well-aware of the accounts mismanagement

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before anyone else. Thus, they gradually reduced their stake before exposing the scandal. Try to avoid companies where promoters have small shareholdings or they are consistently reducing their stake by a huge percentage.

However, reducing promoters' stake is always not bad. The reason behind this is that even promoters have the right to enjoy the profit of their company. It is nothing bad in it if they sell some part of their stake. Moreover, they are in the business for earning money, and they have been working for it since 10-15-20 or even 50 years!!! For an example, promoters of Page Industries were reducing their stake during 2012-2015; still the stock price was appreciated by more than 200% during the same time. One of my investment, Atul Auto is another example. During November, 2013 promoters reduced their stake. Initially, I was worried; however detailed analysis revealed that one of the promoters sold his partial holding to an institutional investor. Initial entry of big institutional investor is the first sign of good times. I had increased my stake based on the entry of the institutional investor. The result paid off. Within the next one year, the stock generated 150%+ return!

So, you need to dig deeper whenever promoters are reducing their stake. It may have a negative or positive effect. Don't take the decision based on the numbers. You need to dig deeper for the real picture behind numbers.

Institutional investor

Institutional investor includes the pension funds, money managers, mutual funds, insurance companies, investment banks and commercial trusts. They buy large quantities of shares leaving a high impact on the stock market's movements. They are considered knowledgeable and experienced. Hence, their footprints are followed by small investors.

Institutional investors are of two types; FII (Foreign Institutional Investors) and DII (Domestic Institutional Investors)

Effects of Foreign Institutional Investors (FII)

Foreign Institutional Investors are considered as the darlings of the company. They are the drivers of the stock market. They are regarded as smart people investing their smart money.

Higher FIIs stake is interpreted as positive, and a lower FII stake means low confidence of FIIs in the company. If FIIs increase their stake, it is considered

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positive as they invest funds only when they are optimistic and confident about the future of the company.

Just like promoters, If FIIs sell their shares then it does not mean that the company is fundamentally weak. Their selling may be due to the economic or political changes, legal problems in their home country or it's just that they want to enjoy their profit. Whatever be the reason, if they offload massive quantities then a huge fall in stock price is witnessed.

Key of multibagger return-

The key to successful investing lies in identifying a stock that can become favourite among FIIs in the near future. In such case stock price multiplied by 3-4 times or more within 1-2 years. For example, I had invested in Ajanta Pharma during December 2012. Back then, the stock was not tracked by brokerage house. The company didn't get enough attention from institutional investors. Slowly, with improved fundamentals, strong financial numbers and better future outlook, the company attracted institutional investors. Since December 2012 to March 2014 FII increased their stake by 3.81%, resulting in an increase of around 184% in FII holdings. No, wonder, since then, stock price generated around 500%+ return (more than six times return) within two years. So, you can create wonder if you can invest in stock before it attracts investment from FIIs (or institutional investors).

Effects of Domestic Institutional Investors (DII)

Institutions or organisations such as banks, insurance companies, mutual fund houses, etc. of a country comprise DII.

Like said earlier money managers are knowledgeable and experienced who keep an eye on every activity of the company. So, they choose the stock based on in-depth analysis and careful observations. Hence, increased investment from DII is positive for any stock.

Combining FIIs with DIIs -

To get a better picture, you need to combine the purchase pattern of FIIs and DIIs. In short, you need to follow the combined portion of institutional activities. Increased holding in this space results in an appreciation of the stock price and vice-versa. However, don't sell your stake just because any institutional investor is selling. Apart from company fundamentals they can sell due to their personal

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needs.

"Increasing institutional holdings is followed by sharp run-up

Effects of Individual Investors

Individuals are many in numbers even lakhs and crores forming a part of the shareholding pattern. But stock prices don't get affected by individual retail investors transactions as shares owned by them is minuscule when compared to the total number of shares. You need to be careful if you find a stock where individual shareholding is increasing while promoters/institutional shareholding is decreasing. It may be an early sign of trouble. Individuals have the least amount of knowledge and are mostly carried with emotions. On the other side, institutional investors are the most knowledgeable (after the promoters). So, you should be cautious if increasing individual shareholdings is resulted due to a significant decrease in institutional holdings.

Summary

Promoters increasing their stake from the open market transaction is always very positive for the stock. Promoters reducing their stake can be either positive or negative. Occasionally, business owners (or initial investors) need to book some profit. However, if there is any forced stake selling by promoters, then it will have an adverse impact on the stock price. Institutional investors (including FII and mutual fund) increasing their stake has a positive impact on the stock price. However, if the maximum permissible investment limit of institutional investors hits the ceiling, then it may cause the stock price correction. Institutional investors decreasing their stake have negative consequences on the stock price. While considering Institutional investors, combine the holdings of FII (Foreign Institutional Investors) and Mutual Funds. Incremental shareholdings of the general public or retail investors have negative consequences and vice-versa. The following chart will summarise the entire portion –

Shareholding Pattern and effects on stock price		
Entity	*Effect on Stock Price*	
	Increasing	Decreasing
Promoters	Positive	Negative/Positive

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Institutional Investors (FII and MF)	Positive	Negative
Retail Investors	Negative	Positive

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Pledging of Shares – Why it is Dangerous for Shareholders?

Like we take loans to fulfil our desire or necessity by mortgaging properties. Similarly, promoters also raise funds by keeping their shares as collateral. High pledging of shares is always dangerous for retail investors. It can cause a sudden crash in stock price. Let's have a look at various aspects of pledging

What is pledging of shares?

Shares are considered as assets, and hence, banks consider shares as security to raise loans. During an emergency, shares can be pledged to raise funds. Pledging of shares is a process when the promoters keep the shares of the company that they own as collateral for the debt. They take loan either to satisfy their personal needs or for funding the company's business. Pledging of shares is done with banks or non-banking finance institutions offering loan to promoters. The loan provided is generally 25%-70% of the share value depending upon the liquidity in the market, type of business and of course the reputation of the promoter.

Why pledging of shares is extremely risky?

Pledging of shares is the last option for promoters to raise fund. It means that no one else is ready to provide loan because either the company is in bad business whose future prospect is not bright or the company has high debt and might be under financial constraints, hence pledging remains the only option left.

During bull market, pledging doesn't create issues because promoters can rely on the optimistic value of their stake. Lenders (Banks/NBFCs) also don't think much because they are also somewhat assured of the rising value of the stake. The problem begins when the market enters in a bear phase. Drop in share price leads to decrease in collateral. It means that the shares that were initially worth of say 100 Cr. are now worth only 50 Cr. To protect the loan amount and limit the risk, the lender asks for more collateral, and hence promoters are forced to pledge more shares. If they don't do this, the lender has the right to sell pledged shares in the market and get his amount recovered. *So, pledging can even lead to promoters losing their stake in the company.* A similar situation happened with Vijay Kantilal Sheth of Great Offshore. Mr Vijay finally left the control of his company in 2009 due to the high level of pledging. He had raised Rs 200 crore by pledging more than 99 percent of his stake.

But there is another aspect also. Many times promoters pledge their shares to expand their business, pay off debts or even to carry acquisitions. Pledging of

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shares become extremely risky when it goes beyond a certain limit, and the company finds itself in a position to do nothing. Promoters who have pledged a significant chunk of their stakes are laden with debt. Shah Alloys is one such example. Promoters of Shah Alloys have 98.71% shares kept as collateral out of their 54%. The company was trading around 150-170 levels during 2005-06 and even touched an all-time high of 252 in May 2006. High pledging of shares was followed by a massive crash in its stock price. Debt of this company is rolling like anything. Another example is Falcon Tyres. During mid-June 2009 promoters had around 78% of their stake pledged out of their 86% share. After one-year promoters had to pledge around 91% of their stake due to demanding conditions. By September 2012 promoters had to reduce their stake to 31.62% out of which 97% of its share kept as collateral. The increase in pledging of shares and reduction in promoters stake led to a huge downfall in its stock price. There are many more examples where high promoter's pledging leads to massive crash in its stock price.

If pledging of shares is so risky then why do Promoters go for it?

Fund-raising is very difficult during adverse macroeconomic situation due to the economic slowdown and the increased cost of borrowing. However to expand the business one needs to raise funds. So, in this scenario pledging of shares has come up with the convenient solution. Another thing is that if any company is already laden with debt then they don't get further loan without collateral. In such scenario, the only option that left is pledging of shares.

On a contrary note, pledging is always not bad. Like we take home loans, car loans, etc. even companies also need monetary support. Similar to our case if we have a consistent cash flow (income) and we are confident that we can return the borrowed amount; there won't be any cause for concern. Similar is the case with fundamentally strong companies. If companies can comfortably handle pledging limit, then there are no issues. If any company has a pledging percentage up to 2%-8%, then it can be ignored.

Pledging of Shares – What Investors Need to Do?

Always avoid companies where promoters are increasing their pledged shares. Investors should keep a close watch on the percentage of shares promoters have pledged. An increase in pledged shares may devastate the earnings of the company, thus leaving no room for earnings growth. High debt follows high pledging of shares. So, a major part of the profit goes to paying the lenders. It

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affects the retail investors by minimising or eliminating the option of sharing dividends. Appreciation of stock price also becomes very less because of low earnings per share.

Pledging of shares put the unnecessary risk on the stock price. Even a quality business can become a victim of such situation. The sudden crash in the stock price is quite common due to the high pledging of shares. So, why you should take such risk? It's better to avoid such stocks.

Following is the list of companies as on August 2014 with the highest and increased pledging of promoters share. Every company in the list underperformed the market (Sensex) over one year and three years period. Throughout 2014 Indian equity market experienced strong bull run even during that time most of the companies with highest (and increased) promoters pledging generated a negative return for investors.

Companies with highest promoters pledging (As on August, 2014)

Company Name	Pledged Shares (%)	Market Capitalization	1 year Price performance	Sensex returns 1 year	3 years Price performance	Sensex returns 3 year
Cairn India	65.81	61311.23	10.13		11.5	
Bhushan Steel	71.84	8623.99	-17.31		6.13	
Religare Enterp.	73.72	5750.24	4.67		-27.82	
Videocon Inds.	67.52	5385.62	-1.6		-7.65	
Pipavav Defence	99.66	3894.55	-21.16		-24.96	
Omaxe	64.64	2293.57	-4.38		5.25	
ABG Shipyard	91.38	1282.42	-8.9		-34.57	
Parsvnath .	92.55	1211.98	-1.07	+27%	-36.27	+36%

"Avoid companies where promoters pledge more than 30% of the holdings and the pledged percentage is increasing"

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4.4 Management Evaluation #2 Dividend History and Tax Rate

Dividend and tax related expenses are the real cash outgo. An accountant can't alter those figures. One can alter sales and income figures through various ways. However, altering dividend and tax figures is not feasible.

"Dividend" is nothing but sharing partial profit with shareholders. As a shareholder, you are entitled to receive dividends (if any) as per your ownership. Companies can re-invest the entire profit into business, or it can distribute a portion of profit to shareholders as a dividend. Companies need to pay dividend distribution tax before offering the dividends to shareholders. It is almost impossible to alter the dividend figures because shareholders ultimately receive the dividend in hand. Companies those are consistently paying dividend over the last 10-20 years must have a solid business. If the dividend figure is increasing every year over the previous five years, then we can assume that the company is in "real" growth track. Higher dividend payout is another symbol of shareholder friendly management. However, don't consider dividend payout number in isolation. A capital intensive business that requires higher investment may opt out to pay dividends for maintaining the growth.

Higher dividend payout ratio with increasing dividend rate confirms shareholder's friendliness of management.

Indian corporate tax rate stands at around 33% (might vary on later dates). So ideally, companies should report tax rate anywhere between 30%-35%. If that is not the case, then you need to dig deeper. Many companies receive tax incentives for manufacturing particular range of products or for operating from a particular zone. However, those tax incentives can't last forever. Over the last 5-6 years if you find the company was reporting tax rate of below 30% (on average) of net profit then you need to dig further.

4.5 Management Evaluation #3 Return on Equity

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(ROE)

Return on Equity is the single most powerful ratio. It can even throw lights on the management quality and whether companies are manipulating their accounts or not. High and consistent ROE is an indication that the management is utilising the capital effectively.

Manipulating account means you have to either overstate the assets portion of the balance sheet or inflate the expense side of the income statement. The beauty is any such occurrence will automatically lower the Return on Equity. Suppose you are overstating profit. So you have to inflate revenue (sales numbers) and understate expenses. Now, your fictitious profit must be stored in the "assets" portion of the balance sheet. By doing so, you are lowering Return on Equity. So, companies which are manipulating their books can't report high ROE consistently. Always consider last 5 year's average ROE. Last 5 year's average ROE of more than 20% indicates that the company is unlikely to be manipulating their accounts. Companies having last 5 years average ROE of more than 20% not only offers immense upside potential but also protects the downside risk. All other things remain same, stocks with increasing ROE would perform better than their counterparts.

4.6 Conclusion -

The combination of great management with great business results into multibagger return from stocks. One of the most prominent examples of this combination is Infosys. Few other examples are Tata Consultancy Service (TCS), HDFC Bank, ITC etc. Figuring such stocks in the early stage is like finding a gold mine. There are many examples of great management with bad business like Tata Steel, Tata Motors etc. Those are a cyclical business. Return from those stocks depends upon macroeconomic factors and economic cycle.

United Spirits under Vijay Mallya was an example of a great business with bad management. Strong underlying business helped the stock offering great return in the past.

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Few airlines stock like Kingfisher Airlines, Spicejet (before 2015 management change) are examples of bad business with bad management. Such stocks are a classic example of wealth destroyers.

Management-Business combination	Stock Return
Great Management – Great Business	**Potential multibagger**
Great Management – Bad Business	**Cyclical return**
Bad Management – Great Business	**Moderate return**
Bad Management – Bad Business	**Wealth Destroyer**

All the above-mentioned management evaluation tests can be conducted from the comfort of your home without any hassles of the physical meeting. In most of the cases, the combination of three tests will deliver the perfect result. For the remaining, you need to dig deeper which is out of scope for small investors. The best way to handle such situation is to avoid it. On few occasion, you won’t get any confirmation from the above mentioned test. Simply avoid those stocks. There are 5000+ listed companies in the market, plenty of options to choose.

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POINTS TO REMEMBER

- It is almost impossible for small investors to visit the management/factory before investing in the stock. There are alternatives for management analysis that can be done from the comfort of your home!
- Promoters increasing their stake from the open market purchase have very positive impact in the stock price.
- Promoters can decrease their stake for various reasons. It can have either positive or negative impact on stock price.
- Stay away from companies where promoters pledge more than 30% of their holdings (and increasing).
- Significant increase in institutional holdings

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Management-Business combination	Stock Return
Great Management – Great Business	**Potential multibagger**
Great Management – Bad Business	**Cyclical return**
Bad Management – Great Business	**Moderate return**
Bad Management – Bad Business	**Wealth Destroyer**

Chapter – 5

Valuation – It Matters Much

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