Honesty and Integrity Investment (HNI Investment)

Email for Sep 2018

Dear Friends,

Here are the details of performance of HNI investment based on the share prices as on 30th Sep. 2018

Annualised Returns (IRR) (1) (2) (3) (4)	HNI Portfolio	Nifty	Sensex
FY13	-10.6%	-5.3%	-3.7%
FY14	112.2%	21.1%	21.3%
FY15	21.6%	25.0%	23.0%
FY16	86.0%	-7.0%	-7.7%
FY17	168.3%	21.9%	20.1%
FY18	***66.4%***	***17.0%***	***18.8%***
Q2FY19	***3.0%***	***13.1%***	***14.2%***
From Inception till 30th June 2018	**81.8%**	**12.8%**	**12.5%**
From Inception till 30th Sep. 2018	***78.6%***	***12.8%***	***12.7%***

(1) For all HNI clients and promoters (2) Inception was in August 2012 (3) Gross IRRs excluding the impact of HNI investment fees (4) Return during the quarter is reported only when it's adverse i.e. negative or lower than Sensex/Nifty. Quarterly IRRs looks overblown due to compounding effects of short periods

We sold one more stock during the quarter with an IRR of 37% (4.5 years holding period). I could not time the sale of this stock well but i never expected that I would be. We still made good money because we bought really well and that's what is more important. We need to buy only when it make sense to buy. Neither, we should buy stocks when/because they have risen, nor we should buy stocks when/because they have fallen. We should buy only when/because the underlying business is worth more than the price being offered. However things are turning increasingly attractive particularly in mid and small caps. I hope soon enough, we should be able to deploy substantial amount of capital.

Now, I would like to share a very interesting story of a corporate fraud that I experienced recently. I will elaborate this experience using dummy names and figures because a) the purpose is just to share few interesting learning and nothing else and b) you cannot be 100% sure in spotting corporate frauds and hence why to bad mouth someone if you are not 100% sure? Please note that the actual figures involved in this whole example are many times more the dummy figures used. So here it goes. So here it goes.

It happens only in India

There was a "Company A" who was in 3 kinds of businesses 1) Branded Goods - to manufacture a particular kind of goods and distributing and selling it under its own brand name 2) Contract manufacturing - to manufacture an intermediate product or parts thereof and sell to other goods manufacturers i.e. to competitors of its own brand 3) Turnkey Projects - undertaking turnkey contracts related to its other businesses for various projects in India and aboard.

One fine day, company announced sale of its branded goods business for 150.2cr to other listed company in India. As per the terms of the agreement, only brands and working capital were to be transferred to the acquirer and rest of the two businesses together with all plants and machinery will remain with the company A.

The acquirer came out with its quarterly results of Q1 and announced that the deal is completed. Acquirer also disclosed all the relevant numbers. As part of the quarterly presentation they said they paid 150.2cr, out of which the acquired net working capital (Inventory+Receivable-payables) is 7.4cr. So the rest 142.8cr should be attributable to acquisition of the brands. Now this consideration of 142.8cr paid for the brands should broadly be the profits in the books of seller i.e. Company A, because the book value of brands was close to zero in its own books.

Many days after the declaration of quarterly results by the acquirer, Company A came out with its Q1 results. Here was a googly. It said, the deal is still not closed pending certain conditions and hence profit from the deal has not been recognized. How in the world it's possible, that the acquirer said that the deal is closed many days before but the seller said that it's not yet!!!. One of them was obviously wrong. Because of this peculiar absurdity, in this particular quarter, working capital involved would have been seating on the books of both the companies in spite of the fact that only one was the owner of it.

Then Q2 results of company A came in which they said that the deal is closed. The profits disclosed due to sale should have been 142.8cr. However they said they made only 94.6cr of profits and that too subject to "closing adjustments". Moreover at the end of Q4 result of the financial year, company again said that profit on sale after closing adjustments was only 66.3cr (not 94.6cr), hence additional exceptional loss of 28.3cr during Q4 of the financial year. How it's possible? Acquirer said that they paid 142.8cr for brands. It was very clear from Company A balance sheet that the book value of brands were negligible. So the consideration paid for the brands i.e. 142.8cr should be the profits for Company A. But it was not so.

So what explains the difference of 76.5cr (142.8cr-66.3cr)? There are two possibilities in my view. First Company A has been inflating its profits over past many years by creating fictitious working capital (inventory/receivables) which is subsequently adjusted from the gains on the sale of the business. Second Company had no fictitious working capital earlier. It actually had all this 76.5cr working capital (inventory/receivables) but it was not sold to acquirer as part of the deal. But the money collected from the subsequent liquidation of inventory/receivables has been siphoned off by the promoters and shown as lost or unrecoverable. I am not sure which is the case here? As expected, there are not enough disclosures either to figure it out.

It makes me wonder what the regulators were doing. I do not expect much from the auditors anyways. They will say ***"Whose Bread I Eat His Song I Sing"***. It also makes me wonder how the income tax authorities cannot catch it. May be there are other priorities that have kept them busy.

However, things are not as bad in India as it looks from the illustration above. There are numerous examples for top notch corporate governance. Forget governance; think of Tatas post the change in management. Tata Sons did not stop, NTT Docomo from winning the case in Delhi high court for a payout of US$ 1.2 billion by Tata sons. The payment was stuck due to RBI permission. If they wish they could have stopped it in Delhi high court or they could have challenged the decision in Supreme Court. But it was not handled that way. I believe that was probably done to keep the word given by TATA.

All of it happened in India. It's up to you which India you would like to create and follow..

That's it for the quarter from my side. Happy to answer any questions that might have…