SageOne

Dear Investors,

Hope you enjoyed reading the 2nd edition of our knowledge series which decoded aspects of financial misrepresentation done by the management of companies to deceive existing investors or potential investors to invest in the company. In this 3rd edition, we would try to capture our perspective on the qualitative research i.e., the non-financial research that goes into building a thesis and determine whether a company is worth investing or not.

As investors of listed companies, we fall in minority investor's category which does not have the luxury and power of private equity category of investors in terms of control on daily functioning of the company or the decision making. Therefore, it is important for us to meticulously analyse various stakeholders of the company which will directly or indirectly affect the future performance (earnings) of the company as thus our returns on the investments. These are:

a) Promoter,
b) Management,
c) **Minority investors – This is 'Us' analyzing others**,
d) Employees,
e) Customers,
f) Suppliers,
g) Distribution Network,
h) Governments, and
i) Trade associations (Competition).

Just like analysing the balance sheet, Profit & Loss Statement and Cash flows Statement of the company is crucial in determining the investment opportunity, going through these non-financial aspects are equally important, especially when the company's business is turning around or the sector in which the company is operating in is coming out of the woods after a long lull period. It is interacting with these stakeholders that we can find the trend of the business performance early and at the same time these checks also help in identifying red flags in the business of existing investee companies.

In this note, we will focus on the "Promoter" out of this entire ecosystem, how at SageOne we analyse the promoter, our past experiences, and the softer aspects that go in our process of investing. There are no fixed formulas to categorize a promoter, as it's very subjective. Since many of the Indian small and midcap companies are managed by promoter themselves, the words promoter and management have been used interchangeably.

PROMOTERS WHO ARE TOUGH TO MEET:

- These are the interesting category of promoters we look forward to but with a caveat. The promoter of such companies can be met only in the Annual General Meeting or after a hard follow up with the promoter giving a reference of commonly known link. Said that, this kind of promoter can be sub-classified further:

  1) Promoter who doesn't meet because not much is happening with respect to performance or future plan of the company and hence, the promoter has nothing exciting to speak; and

  2) Promoter who wants their financial performance to show the strength of the company rather than them speaking about it. They might have an ongoing capex plan for which they would not like to speak till the time the new capex is commissioned and stabilized. In our experience, we have seen that such promoters have delivered consistent financial performance in the past as well.

- We have come across both these sub-categories of promoters during our years of investing. At SageOne, we have invested in companies run by these second sub-category of promoters where we eventually managed to meet the promoter/management, understood the business in depth and invested well ahead of the other investors realizing the potential. We have been successful in identifying a steel tubes/structure company, fishing net company, consumer durable lending focused NBFC, etc. following on the same line. Investing in such companies has helped us in generating superior returns for our clients.

PROMOTERS WHO ARE ALWAYS AVAILABLE FOR INTERACTION WITH THE INVESTORS:

- Just like investors want best quality promoters to be handling the affairs of their investee companies, similarly, promoters also want good quality investors to be sitting in their shareholding list as investors are instrumental in determining the P/E multiple for a company. However, the frequency of these investor meetings might scare potential investor thinking that the promoter spends more time in marketing the company to investors rather than focusing on his/her business.

- While evaluating a food and hygiene ingredient manufacturing company, we required certain financial data for which we specifically requested for a call with Chief Financial Officer (CFO) of the company. However, when the call started, we were surprised to see the CFO along with MD and couple of more senior management level people attending the call to solve our queries which could have done by CFO alone. As a potential investor, we got worried with the fact that the senior management of the company was wasting lot of time for such basic discussions.

IS THE PROMOTER REALLY WORTH MEETING?

- There are promoters/management who misguide investors, who will always paint positive picture despite ongoing weakness extending in their current business operations. As investors, we should never take promoter/management comments and guidance on the face value. We should independently get it vetted by external experts, by studying macro-economic data affecting the business segment the company is operating in, by speaking to distribution channel, competition, etc.

- In our experience over the years, we generally find such category of promoters operating majorly in cyclical sectors. It can never be proven, but just before the start of the business up-cycle when their stock prices are low, some promoters do invest in shares of their own company via name of some other non-promoter group entities to avoid the compliance issues. Such promoters have higher propensity to misguide investors so that they get to exit just prior to the start of the up-cycle and at the highest price possible. In such cases, investors investing at the top looking at glossy financial results and confident guidance from the promoters are the one who are trapped when the cycle turns unfavorable. These trapped investors then go through the mental trauma of witnessing significant wealth erosion in their investments during the down-cycle period.

- It is important to form an independent view unbiased of promoter opinion or guidance in sectors where promoter themselves are clueless on how the future dynamics in their sector will work. On the positive side of the argument, such cyclical companies have potential to give super-normal returns in short time. For that identifying the start of the up-cycle early is crucial which requires persistence in tracking such companies in-depth during the down-cycle, lull, uneventful period where there is no excitement in the business.

RELEVELANCE OF PROMOTER'S CIRCLE

- Friend circle influences the way one thinks or responds. Although it is a difficult task but we do try to find about close associates and friend circle of the promoter to determine the quality of people he/she has been surrounded with. Friends who believe in short cuts, illegal means to operate business will eventually influence the thought process of promoter especially during the tough times.

- Similarly, we try to gauge traits and nature of the promoter from his friend circle to determine whether the promoter is honest, transparent and believe is taking sustainable long-term step or is a short-sighted person.

- Political activeness and inclination of promoter towards political party can potentially affect his business. We have seen promoters of the companies who are close to the ruling political parties getting awarded sizeable contracts and projects on nomination basis. Thereafter when the opposition comes to power, such past contracts and projects awarded by the previous government are questioned which results in the promoter or his company being investigated. Much of the time then gets spent in thwarting this investigation rather than being spent for the business. Therefore, as an investor, it is very important for us to determine whether the business generated is on the merit of the company's offering or it is solely on the basis of promoter's political relationship.

- In our history of investing, we have always avoided investing in companies where the promoters have strong relationship with a top brass of political party, where the establishment of linkage is so direct that the investor community starts relating the company as a company of a political party and the promoter as a senior member of a political party.

PROMOTERS WHO OVER PROMISE AND UNDER DELIVER:

- An investor would always want the promoter to have the highest level of credibility. Regular interaction with the promoters over years helps in determining whether the promoter has walked the talk or not. The probability of a company thwarting failure is high when it is run by a credible promoter. We would always want a promoter to give us positive surprises rather than negative, by exceeding conservative guidance rather than missing an aggressive guidance. Higher predictability of the earnings, credible promoter, provides higher margin of safety and comfort to the investors, thereby allowing him to assign a higher valuation multiple to the company.

- Our experience with one of the construction equipment manufacturers revealed that during good times the promoter's commentary will be so aggressive as if he will be able to utilize 100% of the capacity in no time, but it has never happened in reality. Thus, we always take such promoter's comments with the pinch of salt and always discount their guidance during good business cycle.

- We have also come across promoters who always guide for executing specific actions to improve corporate governance of the company but they never do that. They are always ready with new excuses every time when asked of their past promise to improve corporate governance of the company.

PROMOTER'S SUCCESSION PLAN AND CAPITAL ALLOCATION DECISIONS

- As a minority investor, we want the company to be run by the most efficient promoter/management over the long run. Therefore, having a succession plan in place is equally important. Indian promoters normally don't want to give away the control of the business to another person till the time they are old enough not to be able to manage the business. However, for business continuity and sustainability It is vital for a promoter to delegate the management of the company to an appropriate candidate either someone capable from within the family or a hire a capable professional.

- Sometimes, the next generation of the promoter doesn't want to run the same business and have aspirations to setup their own venture in the quest of creating their own identity. In such cases, it is worth seeing the seeding of these aspirations of the next generation, if is it funded from their personal balance sheet or from the books of the listed entity. If it is funded from promoter's personal balance sheet then it is fine but if it funded from the listed entity then it should be evaluated in detail as it might result in significant capital allocation to an area of business where the listed entity has no expertise in. It could potentially result in substandard operational performance and drag the profitability of entire company in future.

- On the contrary to this view, we have come across companies where the new business verticals which have better operating margins and capital efficiency (ROE, ROCE) are set up in other promoter group companies instead of the main listed entity. In addition to it, the new promoter entity is funded mostly by the listed entity through loans and advances. This should raise an alarm to minority investors as promoter/management focus on the listed company gets diluted, listed company's resources are allocated to run a new business which could have easily been part of the listed entity, thereby depriving minority investors from the benefits of a highly profitable new business.

- The below chart gives few pointers on what we believe is in favour of minority investors or against their interest when we come across any promoter setting up a new business vertical, either for himself or his family members:

New Business of a Promoter

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Pointers for Minority Investors	
Favourable	**Not Favourable**
✓Extention to current business	× Not an extention to current busienss
✓Same customers/same distribution channel	× No synergies to existing business
✓Synergies to reduce cost	× Choking promoter's bandwidth
✓Specialised nature of business	× Significant upfront capital allocation
✓Better ROE/ROCE than exisitng buisness	
✓No upfront significant capital allocation	

- In one of our portfolio companies, we had come across a similar situation which resulted in erosion of market cap of that company, as the seeding of a new business in another promoter group category was taken negatively by the investor community. However, subsequently the promoter acknowledged the gap in corporate governance such business structure would create and subsequently rectified his mistake which finally led to recouping of the erosion.

PROMOTER'S FOCUS ON KEEPING COMPETITION AT BAY:

- It is crucial for promoters to keep their arrogance in check once they achieve market leadership or business superiority. Being complacent about competition can potentially make them sluggish in their approach. We have seen many times that a new competitor with greater zeal and differentiated offering displaces the industry leader. Hence, it is important to observe the conduct of the promoter, his views and opinions on the ecosystem surrounding his business, his vision, his goals. These individual traits of promoter do affect the business performance of the company in the long run.

- We had invested in an inner-wear company in the past where the company had highest market share in the organized segment. Promoter's awareness of what competition is up to played a significant role in keeping this leadership position. Once a multi-national company (MNC) had tried to enter the Indian market with label-less inner-wear to provide comfort to the customers. The promoter upon finding merit in this offering of incoming MNC, turned the entire production line from being labelled to non-labelled inner-wear in a very short period of time. As a result, the differentiated offering was eliminated and the MNC could never find its ground in Indian market.

- Similarly, we are also invested in a building material-cum-FMEG company which gained sizeable market share from a competitor which had a significant hold on the India's western region as the promoter of latter company became complacent after gaining regional leadership position.

CHANGE IN SHAREHOLDING OF A PROMOTER– INCREASE OR DECREASE?

- Analyzing promoters stake helps us determine the level of skin in the game for the promoter and also gauge some inference on the future business prospects of the company. Generally, a low promoter stake in the company gives promoters less motivation to work towards minority investors as there is always a possibility of starting a new business, or idea in an unlisted separate company where the promoter has full or majority ownership. However, there are some exceptions to this. Generally financial institutions like banks and NBFCs have relatively lower promoter ownership as money is the primary raw material for them and they have to dilute their stake constantly to raise fund to grow faster. Also, for a professional turned entrepreneur where the business was seeded by a private equity investor or group of public market investors, in such cases, the promoter ownership always tends to be on lower side.

- In SageOne’s portfolio, baring one out of the entire investee companies (SLP portfolio companies excluded for this analysis), all other companies have promoter holding in excess of 30% and the one less than 30% is because of the exception stated above.

- In India, as per listing agreement, the promoter holding is restricted to maximum of 75%. Hence, if a promoter has less than 75% stake in his business then he can always increase his stake in the business by acquiring more shares from the exchanges if he thinks that the future prospects of the business is brighter. Correspondingly, promoter tends to sell stake in their company when they think that their company have reached peak profitability in the near future and business can see downcycle where there is significant degrowth in the profits of the company. Based on these promoters buying and selling, one can get a soft signal for what lies ahead, however, this is not a full proof formula in deriving any firm conclusion.

- We have come across cases where promoter have sold stake in their companies to upgrade their lifestyle or some major personal expenditure or trying to build non-related business separate of the listed entity. In such companies, despite curtailing their stake, the operating performance of the company has been good and minority investors have been rewarded thereafter as well.

- While studying an e-waste recycling company where the promoter stake was <30%, the management claimed to have set-up a new plant at miniscule capital expenditure, thereby yielding them superior ROCE of ~ 50-60%. This was looking too good to be true. The pertinent question that we had - Why this promoter is doing charity to minority investors? Why is he doing business in listed entity where he had <30% stake? Why not in a private company where he can have 100% ownership thereby benefiting from the entire profits of the project for himself. Also, his existing business in the listed entity was not doing great for him to worry so much about corporate governance, valuation and share price performance of his listed entity. All these dots had a disconnect between them, hence, we didn’t invest in that company and rightly, none of what the promoter guided materialized.

KEEPING A CHECK ON PROMOTER PLEDGE

- Understanding the quantum and reason behind promoter pledge is very important for an investor. Promoters pledge shares of the listed entity either to provide additional security cover to take debt for the working capital needs or the capacity expansion of listed entity. Sometimes they might also pledge shares for the capital needs of promoter's other group entities or for taking debt at personal level. If the pledge is for working capital requirement of listed company itself then it is fine but if it is for other entities, then one should be cautious as the promoters' mind share and bandwidth will get choked in the other company where the debt has been raised and hence, a possibility that the listed company's business affairs might be neglected.

- It is worth finding if the pledge created on shares of listed entity are the first line of assets which will be revoked by the lender in case the promoter defaults on the debt or when the security coverage falls short of the requirement and the promoter is not able to provide additional security coverage to the lender to meet this shortfall. If this is the case, then there is a great chance of promoter losing control over the company if the pledged shares are revoked and sold by the lenders. Subsequently, the promoter's shareholding might go to such a low level that he might not have incentive to manage affairs of the company efficiently.

- Out of our 25-30 investee companies in our actively managed portfolios - SCP and SSP, only 4 companies have promoter pledge in excess of 1%.

TO CONCLUDE:

- **Summarizing the key pointers that we at SageOne like to check before investing:**

  1. We won't mind a promoter being difficult to meet as long as he is maintaining business and financial discipline which can be vetted from past financial performance as well.
  2. Promoter having long term vision in mind rather than one constantly pondering upon different things to give them short term bumps in profits.
  3. Promoter bringing new innovation in the listed company and driving business out of the same entity rather than routing from other unlisted group entities.
  4. Promoters who have adequate ownership in the business for them to align their efforts and focus in the business.
  5. Promoter's long-term goal is to create an institution where senior level management are capable to make business decision themselves rather to create just a company where promoter is the only decision maker for most of the daily affairs of the company.

- There is no straight-forward equation to determine the quality of a promoter. Studying a promoter is really a subjective exercise. It is only our full-time profession and collective years of experience which helps us segregate the promoters across different buckets based on our personal interaction with promoters, speaking to various people inside and outside the investors' community. This is where the Investment Manager's role becomes very important. The assessment framework and network that our investment team has built over time has helped us in being be relatively quicker in identifying the gap in the behavior and conduct of the promoter. It helps in getting answer to a key question, "Can the promoter deliver on what he is saying/guiding?"

We at SageOne aspire to help our readers relate/understand the investment philosophy and approach we follow at SageOne. In this note, we have attempted to enlist some of the most common reg flags so that the trap of investing into mediocre promoter is avoided. We hope you enjoyed reading our compilation as much as we enjoyed putting it together.

Best Regards,

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