Five Red Flags that Investors in Developing Economies Should Know

Anuj Bugga
Managing Director
Global Risk & Investigations Practice
Forensic & Litigation Consulting
FTI Consulting (India)

Bill Sims
Managing Director
Global Risk & Investigations Practice
Forensic & Litigation Consulting
FTI Consulting (Hong Kong)

FTI CONSULTING™

For one American hedge fund, there were many compelling reasons to invest in a U.S. software firm with significant operations in India — 1.3 billion of them, to be exact. With its huge population, a growing middle class of hungry consumers, and domestic enterprises eager for technology that could be used to ramp up to meet local and global demand, India is an irresistible market.

But in the course of conducting its due diligence on the company, the hedge fund managers started to hear rumors that the firm was exaggerating its success. Published research reports indicated that the company's Indian sales figures were inflated. Even worse, the reports suggested that the company's Indian subsidiaries might not be much more than shells.

To make an informed investment decision, the hedge fund needed to know if those allegations were true. But its Indian office was staffed by one employee, and it didn't have the resources to conduct an investigation. And discretion was of utmost importance. The fund did not want the target company to find out it was being looked into lest it seek to cover its tracks and possibly suborn sources that might know the truth.

The fund brought its concerns to FTI Consulting's Global Risk & Investigations practice. The fund needed to know if the firm's Indian operations were legitimate. Was it selling software at the rate the numbers indicated? Did it own all the offices it claimed it did? Who and what should the hedge fund believe?

Strangers in a Strange Land

Among foreign investors, there is no shortage of cautionary tales about deals that have gone awry in developing economies throughout Asia. But India presents special challenges. Investors can be lulled into a false sense of security due to superficial familiarity, especially given the widespread use of English among businesspeople. However, India's unique business culture makes it unlikely that routine due diligence processes will distinguish between red flags that are simply facts of Indian business life and red flags that should put investors on alert.

Bureaucratic bottlenecks may be business as usual (Indian red tape is legendary) or they might signal that bribes are being dangled, waiting for some official to take the bait. Well-connected but often ill-informed independent directors on the board of Indian companies are quite common, but such presence also can indicate lax corporate governance or something worse. It's hard to tell, and shuffling through financial documents rarely provides definitive answers. That requires boots on the ground.

For the U.S. hedge fund, FTI Consulting's investigators in India used their contacts to talk with a variety of sources, ranging from regulators to competitors, vendors and clients. With accurate business intelligence, it quickly became apparent that the software company certainly was not doing business on the scale it claimed.

Arriving at one of the company's alleged facilities, FTI Consulting investigators found it to be a residential apartment — an unlikely place for producing software. Although the company had more than 1,000 employees on its payroll, it paid them significantly below the industry standard. This would make it difficult to attract qualified developers, as FTI Consulting's team confirmed by speaking with ex-employees. As a result, the quality of the company's products was mediocre, service was poor, and local industry experts asserted that the company was losing customers and revenues to competitors.

FTI Consulting concluded, however, that neither the firm's Indian operations nor its market reputation were of concern to the software company's management; it was just using the Indian business as a front for revenue generation. The rising value of the firm's Indian entities came entirely from the trading of shares between related entities at excessive premiums. Furthermore, the investigation discovered that the company's "promoter" (the title for a person in India who seeks investors for a business) previously had worked with companies that had been accused of accounting fraud.

These were red flags that needed to be taken seriously.

Blinded by Economic Opportunity

Foreign investors are keen to put their money into fast-growing, increasingly friendly economies like India's, and waving away red flags may be a reflection of investor over-eagerness. With gross domestic product projected to grow at 5 percent this year, India's economy gained added momentum last May when a unified government, backed by a single majority party, was elected to office for the first time in three decades. The markets soared in response due, in part, to new Prime Minister Narendra Modi's track record as the business-friendly chief minister of the western state of Gujarat. The government has loosened certain restrictions — reducing paperwork and cutting down on inspections – and relaxed restraints on foreign domestic investment in the defense and insurance sectors.

India's reputation as a venue for investment is soaring. In September 2014, Modi helped procure $35 billion in Japanese investments over the next five years, doubling Japan's previous commitment to the country.

But when it comes to gaining in-depth knowledge of Indian and other companies in emerging economies, documents alone will not suffice.

The Indian government also has vowed to crack down on a problem that has long deterred investors: corruption. In Transparency International's annual Corruption Perceptions Index, India landed at 94 (out of 177 countries) in 2012 and 2013. The country's ranking stood at 84 in 2009, the same year that one of its largest information technology companies revealed that it had committed accounting fraud, overstating revenues and exaggerating profits by about $1 billion. By 2011, the country's Transparency index ranking had slid to 95.

The prevalence of bribery and other forms of corruption — often difficult to detect — combined with increasingly energetic regulatory enforcement in the United States have spread jitters among U.S. investors who reasonably fear running afoul of Sarbanes-Oxley and Foreign Corrupt Practices Act laws.

Why Standard Due Diligence May Yield Substandard Results

Typically, the mention of corporate due diligence conjures images of ever-rising stacks of documents awaiting review by sharp-eyed experts.

But when it comes to gaining in-depth knowledge of Indian and other companies in emerging economies, documents alone will not suffice. In India, the lack of uniform practices across the country's states, in addition to inconsistent enforcement of laws and regulations, creates a situation in which publicly available documents almost always are incomplete and, as a result, often misleading.

In part, that stems from the nature of corporate ownership in India, where very large, even publicly listed, companies frequently are family owned and run. Those family ties commonly extend to directors identified as independent. Such family enterprises may be structured one way on paper and another in practice, with just a few decision makers in charge. Departments such as human resources, tax and legal may exist as a company's documents claim, but any given department's influence may be hard to discern.

With authority concentrated in relatively few hands, networks of powerful families are in a position to pressure political connections to secure contracts and leverage other forms of political influence. That dynamic, combined with the absence of robust corporate governance, fosters ample opportunities for malfeasance.

Top management may collude with its auditor, for example, to produce an unrealistically rosy view of a company's financial health, deferring expenses for the sake of boosting current earnings or underreporting liabilities. Unearthing a company's actual business practices requires more than document reviews and database searches that Western companies are accustomed to conducting as part of pre-investment due diligence.

While digging into a company's financial statements and decision-making structure helps mitigate investment risk, contacting competitors, suppliers, customers and ex-employees of the target company improves the quality of the information. By having multiple sources can corroborate specific allegations, investigators can produce a more accurate analysis of a company, gaining valuable insights into its actual operations, political connections and business affiliations.

Recently, FTI Consulting was approached by a Hong Kong-based business and asked to investigate a company the firm was considering acquiring. The client had spotted a potentially troubling red flag: About 75 percent of the revenues of the target company, based in mainland China, came from large government contracts. The acquiring company's own auditor had questioned the predominance of such contracts but ultimately opined that nothing was amiss. FTI Consulting found multiple sources that reported these contracts had been obtained through bribes to provincial officials.

Any prospective acquirer would want to know such intelligence *before* any deal is struck. Apart from the serious regulatory risk of being associated with bribery, revenues will start to drop almost the moment an acquirer takes over and, wittingly or not, turns off the bribe spigot.

A predominance of government contracts within a company's customer base is a red flag meriting further investigation. There are others.

Five Red Flags: A Brief Review

Inconsistencies in any company's financials are bound to raise questions. But absent sufficient knowledge about the workings of the jurisdiction in which a company is operating, investigators may lack context for evaluating answers they're given. Such investigators may be more susceptible to accepting vague, or even fabricated, explanations. Based on our experience, following are some red flags that can't (and shouldn't) be explained away.

A sudden and significant drop in returns

It is not uncommon in India and elsewhere in Asia for owners of companies to have undisclosed conflicts of interest. Company founders can set up competing firms in the name, for example, of their spouse, adult children, father or grandfather that can be used to siphon revenues and profits, lowering investor returns. In one investigation in China where clients were not getting the earnings they had anticipated, FTI

Consulting discovered the company's chief executive officer had funneled money into setting up a competing business in the name of his 82-year-old grandfather, thereby pocketing returns that should have gone to investors.

Nº2

Profits and revenues claimed above the industry norm

When a company announces profits far above the industry norm, it's important to make sure they have not been generated through a bribery scheme or creative accounting. In one investigation FTI Consulting undertook in China, a prospective joint venture partner had inflated its revenues significantly by fraudulently taking advantage of the Chinese government's value-added tax ("VAT") refund. The company's senior management had bribed officials to inflate the value of the goods it exported. The paperwork was submitted to the central tax authorities in Beijing, enabling the target to claim and receive sizable VAT refunds based on spurious figures. In this case, the company's finances had been audited by a Big 4 firm prior to FTI Consulting's involvement. Although the auditing firm had noted the outsized profits on exported goods, it ignored the red flag this raised.

Nº3

Too many subsidiaries

Multiple subsidiaries create complexity that may indicate that suspicious transactions are being hidden. When a company has been splintered into a number of entities, it's up to the investing party to make sure it signs a contract with the appropriate subsidiary. It may turn out that the constituent entity cannot perform a contracted task such as financing a merger or acquisition transaction. Multiple subsidiaries can be used to reduce corporate liability and risk. And digging into transactions among subsidiaries may reveal that the ultimate beneficiary of profits is a relative of the owning family and that the purpose of that entity is to funnel money into ventures outside the company's core business. In one organization investigated by FTI Consulting, the subsidiaries turned out to be shells with no real operations, established for the purpose of channeling money into real estate.

Nº4

Sudden increases in "other income"

Increases in "other income," whether through asset sales, debt restructurings or share sales, bear close scrutiny. In one situation, FTI Consulting discovered that the Indian subsidiary of a U.S. company had no revenues. The subsidiary was being used to funnel money from the United States to offshore investments in Singapore. Similarly, sudden jumps in stock price merit more on-the-ground intelligence gathering. The company may be inflating profits by bypassing regulations or avoiding taxes.

Nº5

Overreliance on government incentives

As a nation with an unfavorable trade balance, India has policies (tax exemptions, duty drawbacks and so on) to promote exports. One Indian maker of medical devices took advantage of these policies by routing its products for Europe and the United States to distributors in Asia and the United Arab Emirates. These distributors repackaged the devices to disguise their origin and shipped them back to India to a subsidiary of the company that handled domestic sales. The subsidiary sold these putatively foreign medical devices (which the Indian public perceives to be of superior quality) at higher prices to Indian customers. Thus, the company had colluded with overseas distributors and the Customs department in India both to avail the organization of government incentives for exporters and to artificially inflate revenues by charging higher prices for the goods. Also, India has Special Economic Zones, where companies that export software can receive tax benefits. To avoid taxes, companies will invoice their exports as if all operations are located in such a zone when, in fact, they are not. This is fraud.

Going the Extra Mile

Accounting scams happen everywhere, not just in developing economies. Still, investors should assume that publicly available information in these economies will not provide a sufficiently complete financial picture upon which to base an investment decision.

In most cases, that picture cannot be filled in from the comfort of headquarters. The colors and shadings of a target company's true nature need to be viewed up close. After reviewing FTI Consulting's findings, the managers of the U.S. hedge fund knew that many of the rumors they had heard regarding their prospective investment in the software company in India, in fact, were grounded. While FTI Consulting's involvement ended with the presentation of its report, the hedge fund's managers clearly were in a better position to make decisions about their investment strategy going forward.

Relying on routine methods of due diligence in India and other developing economies signals that a company is taking an unnecessary risk and may very well end up investing based upon an incomplete and inaccurate sense of a target company's situation. And that, in itself, is another and very serious red flag.

Anuj Bugga
Anuj.Bugga@fticonsulting.com
Managing Director
Global Risk & Investigations Practice
Forensic & Litigation Consulting
FTI Consulting (India)

Bill Sims
William.Sims@fticonsulting.com
Managing Director
Global Risk & Investigations Practice
Forensic & Litigation Consulting
FTI Consulting (Hong Kong)

For more information and an online version of this article, visit ftijournal.com.