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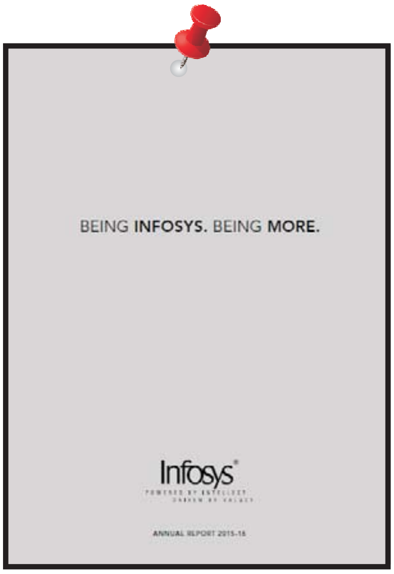
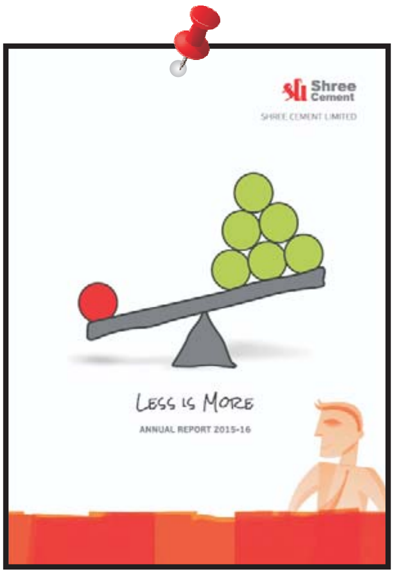
October 2016





Forget great boards, look for great annual reports

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Forget great boards, look for great annual reports

Our recent book, *['The Unusual Billionaires']*, makes a case for a strong board of directors. However, investor feedback indicates that the quest for a strong board is both idealistic as well as biased by the 'halo effect'. Instead, we believe that investors should look for great annual reports. Not only are outstanding annual reports easier to spot, frank and clear communication and disclosures beyond mandatory requirements are indicators of high standards of corporate governance and the management's clarity of thought & purpose. While a great annual report might not always make for a compelling BUY argument, a weak annual report is usually a SELL signal.

Dispelling the myth of great boards

There are great boards and bad boards. However, their effectiveness in protecting minority interests or even ensuring high standards of corporate governance is unproven. Great boards can make questionable decisions and a promoter-led board can also be minority-friendly. Thus, we believe that the qualities of a strong board of directors are subjective and vulnerable to the halo effect – attributing a company's success to a great board when the real reason might be completely different.

The case for clear communication

Great boards are only one aspect of high corporate governance standards. We believe that companies must be clear about: (1) their objectives, (2) their strategies to achieve them, and (3) consistently communicate them with their shareholders. We believe this three-step process provides a far more robust, and sustainable, framework for corporate governance. The annual report is a critical document to achieve this purpose. Being the single-most comprehensive communication with shareholders made during the year, the annual report is a great indicator of a promoter's clarity of thought and his intent.

Lessons from our case studies

We provide six case studies of great annual reports: a) **Infosys:** one of India's largest companies that set the standards for disclosures from its early days; b) **BPCL:** even public sector enterprises (PSEs) can set high standards of communication & disclosures; c) **Bajaj Finance:** an NBFC that has been transformed over the past five years and has sustained high standards of disclosure; d) **Shree Cement:** comprehensive commentary on maintaining competitive advantages; **e) Marico:** overall high quality annual report with a focus on capital allocation and employee culture; and **f) Balrampur Chini:** clear communication of objectives and discussion on key aspects of the business.

The great annual report checklist

Based on these case studies, we provide a checklist to spot a great annual report. We believe promoters must: a) go beyond legal requirements and provide data on key financial and operational parameters to help investors understand the business better; and b) supplement this with an honest discussion on the company's financial performance and its strategy to meet its objectives. Annual reports that meet these objectives will uphold higher standards of corporate governance beyond having great boards.

Some companies with great annual reports

Company	Mcap ($mn)	Stance	Comment
Infosys	35,843	BUY	Goes beyond mandatory disclosures, in-depth data, exhaustive discussions.
BPCL	13,646	BUY	Consistently high standards of disclosure among PSEs.
Shree Cement	9,370	SELL	Detailed discussion on sustaining competitive advantages
Bajaj Finance	8,800	SELL	Maintained high standards through transformation of core business.
Marico	5,469	BUY	Detailed discussion on brands, capital allocation, and employee culture.
Balrampur Chini	397	NR	Clear communication of objectives, candid discussion of challenges faced by the company.

Source: Bloomberg, Ambit Capital research
Note: NR indicates Not Rated

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Section 1: Busting the 'Great Board' myth

"Delusion One: The Halo Effect: The tendency to look at a company's overall performance and make attributions about its culture, leadership, values and more."

- Phil Rosenzweig, 'The Halo Effect' (2007)

Praise for a great board of directors...

"The Unusual Billionaires" discusses great boards of directors of companies like Asian Paints and Marico

In August 2016, we published "The Unusual Billionaires", a book about seven Indian companies that have consistently delivered superior financial performance. The book contains detailed discussions on the high quality and true independence of the boards of directors of companies such as Asian Paints and Marico. By high quality we meant reputed professionals with considerable work experience that would be invaluable to the company.

This quote from B.S. Nagesh in the chapter on Marico, encapsulates the power of a board of directors packed with independent professionals: "*Boards build the effectiveness of management. So a promoter supporting and listening to the board, although he is a 60 per cent shareholder, makes us independent directors feel proud because we think that we are able to contribute to Marico. All major decisions impacting shareholders are discussed thoroughly with the board. The board is also involved in recruiting the CEO and one level below the CEO. An effective board gives Marico a combined experience of other big companies like Diageo and Mondelez, which adds tremendous value to the organisation. These things don't reflect directly on the balance sheet, profit and loss statement (P&L) or share price, but these are inputs which go into creation of long-term shareholder wealth."*

...is vulnerable to the halo effect

We recognise that a great board is idealistic in nature

Our focus in this note is on *great* boards, not just *independent* boards. Almost all Indian companies comply with the legal requirement of having more than 50% of directors as independent, but very few go beyond this and employ top-notch professionals in their boards. In that regard, the quality of the independent directors on the boards of Asian Paints and Marico is exemplary and we have no doubt that a board of this quality can become a source of competitive advantage to the company. However, we also recognise that a great board is idealistic in nature.

Upon reading 'The Unusual Billionaires', several investors told us that the assessment of good or bad boards suffers from the halo effect. Describing this cognitive bias in his 2007 classic book, 'The Halo Effect', Professor Phil Rosenzweig described the Halo Effect, as *"The tendency to look at a company's overall performance and make attributions about its culture, leadership, values, and more. In fact, many things we commonly claim drive company performance are simply attributions based on prior performance."* Thus, great companies are imbued with a halo that their success must be because of strong boards, whereas the reason could be completely different.

Whilst we don't necessarily agree that there is no such thing as a bad board (for example, a board packed with friends and family cannot be good for minority shareholders), we understand that assessing boards is a highly subjective matter. However, the benefits of a great board – or the drawbacks of a weak board – are difficult to quantify for the following reasons:

In the U.S., the idea of a strong board remained moot

a) Strong boards are also prone to making mistakes: In the U.S., which has a more shareholder-oriented, free market economy than India, the idea of a strong board remained moot given the occurrence of large corporate scandals in the early 2000s such as Enron and Worldcom. An HBR article of 2002[1] described Enron's board as follows, *"Despite Enron's disastrously complex financial schemes, no corporation could have had more appropriate financial competencies and experience on its board. The list includes a former Stanford dean who is an accounting professor,*

[1] https://hbr.org/2002/09/what-makes-great-boards-great

the former CEO of an insurance company, the former CEO of an international bank, a hedge fund manager, a prominent Asian financier, and an economist who is the former head of the U.S. government's Commodity Futures Trading Commission. Yet members of this board have claimed to have been confused by Enron's financial transactions."

In his 2003 annual letter[2] to shareholders, legendary investor Warren Buffett blamed the failure of independent and decent directors on the boardroom atmosphere. He wrote, *"It's almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his inside staff and outside advisors are present and unanimously support his decision. (They wouldn't be in the room if they didn't.) Finally, when the compensation committee – armed, as always, with support from a high-paid consultant – reports on a mega grant of options to the CEO, it would be like belching at the dinner table for a director to suggest that the committee reconsider."*

Illustrious boards in India also haven't always proved to be effective

In India as well, illustrious boards haven't always proved to be effective. For example:

- In April 2009, Axis Bank's Board refused to consider the successors chosen by then chairman, Dr. P.J. Nayak, to replace him. As a result, Dr. Nayak resigned from the bank that he had turned around successfully and led since he took charge in 2000. Axis Bank's board was studded with independent directors who were professionals with many years of work experience; Dr. Nayak himself had a proven reputation for strong leadership and unimpeachable integrity. Yet, for reasons unknown, the board chose an outsider, Shikha Sharma, to lead the bank after Dr. Nayak. Admittedly, Mrs. Sharma has done a stellar job since then, but the board's decision in 2009 remains a mystery. [In May 2009, veteran financial journalist, Sucheta Dalal, wrote on this remarkable board meeting: https://goo.gl/DgY4Gt].
- In January 2014, the board of Maruti Suzuki approved the expansion of its Gujarat plant through a 100% Suzuki subsidiary. Doing this would shortchange the minority shareholders of Maruti since the benefits of the plant would flow directly to Suzuki. And yet, Maruti's board, which was then filled with professionals who were ex-CEOs, prominent chartered accountants and lawyers, took this anti-minority decision. Following opposition from institutional shareholders, Maruti did change some of its terms later, but the fact remains that this decision was first made with the approval of the independent, professional directors present on the board. [The controversial decision made by Maruti's board was covered in detail in the news media: https://goo.gl/gyNPkq]

A committed promoter can also succeed without a strong board

b) Promoter-led boards can also perform well: As 'The Unusual Billionaires' shows, a committed promoter can also succeed without a strong board. The experiences of Astral Poly and Page Industries show that promoters who are focused on their core competencies, on building competitive advantages, and sensibly allocating capital can achieve the same measure of success as companies with a strong board. We also highlight that smaller companies are at a natural disadvantage when it comes to attracting talent in the board room since prominent professionals seek more compensation and prefer to become independent directors of larger, high-profile companies.

There is no standard wish-list of qualities of a strong board

c) Qualities of a strong board are subjective: There is no standard wish-list of qualities of a strong board. In fact, qualities that appear good in theory might not be as desired in real life. For example, an independent director serving for too long on the board could be perceived as being close to the management and, hence, having his objectivity compromised. However, a motivated promoter can sway independent directors irrespective of their tenure. And, a committed independent director can still take decisions in favour of minority shareholders. For example, Rajesh Ambalal Shah has served on the board of BASF for 47 years, as per a Mint article[3] of Oct 2015, and yet took a pro-minority decision when the need arose: *"Some four years ago, BASF India came up with a proposal that the parent company of the multinational should be*

2 http://www.berkshirehathaway.com/letters/2003.html
3 http://www.livemint.com/Companies/zCJe3Ep6jtbTYuOLJjxFSN/Is-Rajendra-Ambalal-Shah-Indias-most-misunderstood-independ.html

paid a royalty that amounted to 30% of the pre-tax profit. As an independent director on BASF's board, Shah opposed the proposal. The fact that he had been a director of that company for a long time equipped and qualified him to say, "I am sorry, am not a party to this. I am supposed to protect the interest of all the stakeholders—I don't think this is fair to minority shareholders," said Shah."

Similarly, while directors on the verge of retirement are seen as well past their prime, they also possess invaluable experience that no young, spirited director can provide. This anecdote, from the previously mentioned 2002 HBR article, is useful, *"Michael Dell (Dell Computer placed tenth on Fortune's 2001 list of most-admired companies) told me that when he incorporated in 1987, as a 21-year-old college dropout, he found it invaluable to have then 70-year-old George Kozmetsky, Teledyne's visionary founder and the former dean of the McCombs School of Business in Austin, Texas, serve on the board; Kozmetsky stayed for more than a decade."*

Untested correlation between strong boards and alpha

In our book, we have shown that consistent, superior financial performance drives superior returns for shareholders over the long term. Some of our 'Unusual Billionaire' companies have strong boards and some do not. Hence, a strong board is neither a necessary nor a sufficient condition to ensure healthy returns for shareholders. In the end, companies whose promoters are focused on their core business, create moats, and allocate capital sensibly should ideally sustain superior financial performance and this, in turn, should lead to strong shareholder returns. Corporate governance plays a very important role to protect minority interests. However, strong corporate governance (of which strong boards are a subset) on its own does not lead to superior financial performance and alpha.

The 'great board' debate has the potential to be endlessly subjective and idealistic

Thus, we conclude that the 'great board' debate has the potential to be endlessly subjective and idealistic. While promoters can aspire to a great board, we believe a more practical and realistic approach to high standards of corporate governance is communicating objectives in a lucid way to the shareholders.

In this regard, no communication is as important as the annual report. In the next section we look at great annual reports and what sets them apart. Finally, we prepare a checklist for preparing great annual reports.

Section 2: Why great annual reports matter

"Statistics are like a bikini. What they reveal is interesting. But what they hide is vital"

- Aaron Levenstein, former Business Professor at Baruch College in "The Wall Street Journal Essential Guide to Management" (2010)

Why do great annual reports matter? We believe great annual reports clarify a company's governing objectives. They highlight the approach that a promoter takes to build a business. They discuss recent performance in a clear manner and also help in understanding the accounting policies that are followed to present the financial statements for the year. Ambit's research is based on reading ten to twenty years of annual reports to understand the evolution of a company; accounting quality remains the cornerstone of our research, as evidenced by our extensive reports over the years on this topic.

Clear communication of corporate objectives is critical

Defining corporate objectives and communicating them to shareholders is dependent on promoters

Corporate governance practices are well-established and defined under corporate law (Companies Act 2013, Listing Agreement with the stock exchanges). However, defining corporate objectives and communicating them to shareholders are dependent on promoters. We believe this clarity of objectives and communication to shareholders should be a part of corporate governance.

In their July 2016 article[4] for the Harvard Business Review, titled *'Reclaiming the idea of shareholder value'*, investment strategist Michael Mauboussin and economist Alfred Rappaport noted three steps to establish an effective corporate governance structure: 1) select a clear governing objective, 2) adopt a set of policies that encourage behaviors consistent with the governing objective, and 3) communicate with all stakeholders.

Specifically on #3 above, they write,

- *"This includes public disclosure of a governing objective, the time horizon the company will use in its planning and decision-making processes, how it will resolve trade-offs among stakeholder interests, and the specific policies in place that support the governing objective.*
- *This communication allows all stakeholders, including shareholders, to opt in or opt out given a company's objectives. In particular, CEOs who are compelled to disclose their time horizons are likely to lengthen them. This disclosure alone would serve as a powerful antidote to corporate short-termism."*

Thus, clear and consistent communication is a part of strong corporate governance practices. Great annual reports are part of this communication to shareholders and reflect well on the management of a company and its promoters.

Importance of making great annual reports

Any company – small or big, profit-making or loss-making – can write great annual reports

Just like there are no pre-defined rules for a great board of directors, there are no such rules for great annual reports. However, while all companies might not get a great board of directors, any company – small or big, profit-making or loss-making – can write great annual reports.

In 1998, the Securities and Exchange Commission (SEC) in the US released[5] *'A Plain English Handbook: How to Create Clear SEC Disclosure Documents'*. Writing its preface, Warren Buffett provided this tip, *"One unoriginal but useful tip: Write with a specific person in mind. When writing Berkshire Hathaway's annual report, I pretend that I'm talking to my sisters. I have no trouble picturing them: Though highly intelligent, they are not experts in accounting or finance. They will understand plain English, but jargon may puzzle them. My goal is simply to give them the information I*

[4] https://hbr.org/2016/07/reclaiming-the-idea-of-shareholder-value
[5] https://www.sec.gov/news/extra/handbook.htm

would wish them to supply me if our positions were reversed. To succeed, I don't need to be Shakespeare; I must, though, have a sincere desire to inform."

To explain our point further, we provide the following quotes by Warren Buffett, who once said[6] *"I just sit in my office and read all day"* and is famous for spending 80% of his time reading:

"I just sit in my office and read all day" – Warren Buffett

- In 2008, explaining why his investment in PetroChina was based mainly on its annual report: "*I read it in the spring of 2002, and I never asked anyone else their opinion. I thought it was worth $100 billion after reading the report. I then checked the price, and it was selling for $35 billion. What is the sense of talking to management?*" [Source[7]]
- In 2014, why PetroChina's annual report was so good: *"I sat there in my office and I read an annual report, which fortunately, was in English and it described a very good company. It talked about the oil reserves, talked about the refining, and talked about the chemical and everything else. I sat there and read it, and thought to myself 'this company's worth about $100 billion"* [Source[8]]
- In a 2016 interview to Jason Zweig of the WSJ for an article on a fund manager called Geoffrey Abbott who is on a goal to read the annual reports of the 3,000 largest companies in the US: *""Over the years, there have been multiple times when reading the annual letter has been a factor in my deciding to do something or not to do something," Mr. Buffett told me this past week when I mentioned Mr. Abbott's project. Reading a letter was never "the deciding or dominant factor," he said, "but it was definitely often a factor.""* [Source[9]]

In short, a great annual report is one that obviates the need for investors to meet the management of a company.

Cornerstone of Ambit's research: Accounting quality based on Annual reports

Annual reports are ideal places to spot accounting misstatements with the use of forensic analysis. Using trend analysis of forensic ratio, changes in patterns can be spotted and any change that does not have a plausible explanation can be flagged. (If you want to understand how this can be done, click here for our December 2015 forensic accounting note.)

At Ambit, we have consistently used annual reports over long periods of time to sift the good from the bad and the ugly

At Ambit, we have consistently used annual reports over long periods of time to sift the good from the bad and the ugly. Our analysis covers financial statements, from schedules to notes to accounts, from director's report to auditors report. A summary of our reports over the past years is as follows:

A list of our reports that have an in-depth analysis of annual reports

- In January 2013, our report titled 'The importance of accounting quality' showed how the relationship between good accounting and positive investment performance was tightening over time. click here
- In May 2013, our report titled 'Indian Annual Reports: Facts or fiction?' listed case studies of how to navigate through camouflaged annual reports, identifying the most popular accounting tricks that corporates use to mask the true health of their businesses. click here
- In March 2014, our report 'The underbelly of Indian IT sector' presented case studies of companies (classified as 'ugly', 'bad' and 'not so good') that underperform on accounting and corporate governance standards. click here
- In December 2015, our forensic analysis report titled 'Are you in the 'Zone of darkness'?' proved how, even in flat markets, companies with poor accounting quality underperformed and must be avoided. click here

[6] https://www.farnamstreetblog.com/2013/05/the-buffett-formula-how-to-get-smarter/
[7] http://basehitinvesting.com/buffetts-petrochina-investment-finding-large-gaps-between-price-value/
[8] http://www.biznews.com/interviews/2014/12/16/warren-buffett-how-to-make-3-5bn-on-a-500m-investment/
[9] http://blogs.wsj.com/moneybeat/2016/04/01/its-time-for-investors-to-re-learn-the-lost-art-of-reading/

- Our portfolios, Good & Clean to *Good & Clean 11*, 10-baggers *Tenbagers 5*, and Coffee Can [*Coffee Can report* from late 2015.], extensively analyse annual reports over many years to sift great companies from mediocre ones.

We believe that disasters can be spotted in advance on a careful reading of the annual report and where applicable, we also analyse financial data filed with the SEC, USA. Hence our analysts extensively crunch many years of annual reports to spot issues pertaining to accounting quality.

For example, in our note titled 'Risk is still building up' released in July 2015 *click here*, we analyzed ICICI Bank's 20-F filing and highlighted (i) Early delinquencies increased sharply between FY14 and FY15; (ii) Largest exposure to a corporate group further increased; and (iii) In stressed sectors like metals/infrastructure, the stressed asset ratio was still significantly lower than the rest of the banking system despite having similar exposure. Based on our analysis, we warned that the pressure on ICICI Bank's asset quality is likely to continue, with addition of fresh bad assets and with increased slippages from restructured assets; this would lead to provisioning cost rising materially in FY16E. In FY16, our warning proved to be correct as ICICI Bank reported a whopping 200bps increase in gross NPAs, 180bps rise in credit cost increase (vs average 75bps in previous five years) and total stressed loans reaching 12% of bank loans. Then in July 2016 *click here* we provided further analysis of ICICI Bank's next 20-F filing and said that whilst there is marginal moderation in asset quality stress, it is still elevated. Hence, probability of elevated levels of slippage and credit costs remains high for the bank. While the FY17 annual report is still some time away, we remain SELLers in the stock.

We now move to specific examples of great annual reports and what made them stand apart. For the sake of brevity, we have chosen only six companies whose annual reports stand out in terms of disclosure and discussion.

1. Infosys

Infosys has a long track record of going beyond mandatory disclosures

Infosys has a long track record of detailed annual reports that go beyond mandatory disclosures. While the practice of issuing quarterly reports with quarterly results is a norm now for many companies, Infosys' first quarterly report (https://goo.gl/LnIAfL) dates back to the quarter ended 30th June 1999 – more than 17 years ago. We highlight the following:

- In its FY99 annual report (https://goo.gl/5p2kXi), Infosys had more than 10 pages of additional information to shareholders such as an intangible asset scoresheet, revenue from Top 5 and Top 10 clients, average age of employees, average quality of employees (via an information index), segmental reporting by geography and business segment, and a detailed organisation chart.
- We note that Infosys's practice of going beyond mandatory disclosures continued even when TCS – Infosys's largest competitor – listed in 2004. In fact, a comparison between TCS' first publicly available annual report (FY05) and Infosys's annual report for the same year shows this difference in disclosure between the two companies.
- For example, Infosys continued its practice of disclosing client concentration, making it into a separate, seven-page 'Risk Management Report'. In comparison, TCS disclosed client concentration only in its FY07 annual report (https://goo.gl/mQG6A3) and that too within the Management Discussion and Analysis (MDA) on page 55.
- In terms of management commentary, Infosys continued its practice of detailed write-ups from its senior management (Basab Pradhan, S. Gopalakrishnan, Ravindra, Deepak Sinha, Shibulal, and Mohandas Pai), while TCS' annual report contained a Chairman's statement, director's report, and MDA. Only in its FY07 annual report did TCS include statements from senior management (S. Mahalingam, N. Chandrasekaran, S. Padmanabhan, and PA Vandrevala).

2. Bharat Petroleum Corporation Limited (BPCL)

High standards of corporate governance aren't exclusive to the private sector. We believe that some public sector enterprises (PSEs) also make great annual reports and highlight BPCL as a case study. While all three oil marketing companies – IOC, BPCL and HPCL – have high quality, detailed annual reports, we highlight BPCL as being marginally above for the following reasons:

Some public sector enterprises (PSEs) also make great annual reports

- In FY98 (https://goo.gl/jpq8Np), BPCL had reorganised its business around six strategic business units (SBUs), namely, Retail, Industrial and Commercial, Liquefied Petroleum Gas, Lubricants, Aviation, and Refinery. This clarity in objectives was communicated well in the company's annual reports. Moreover, BPCL provided detailed performance reviews for each SBU in its subsequent annual reports.
- As far back as 2000, the oil sector stood at a crossroads that appear similar to 2016, namely: *"deregulation, disinvestment, retailing revolution, and the e-commerce boom"* (page 15). The FY00 annual report (https://goo.gl/Ww2UYt) stands out in terms of how BPCL explained its transformation: *"In order to sustain growth and profitability in the years to come, BPC has embarked on an effort to transform the organisation into a market savvy-one that could react, strategise and implement change faster"*, followed by its strategy, *"A business planning process has been put in place that not only provides for opportunities for the SBUs to pursue their visionary goals in consonance with the corporate vision, but also continuously monitors trends and identifies strategic opportunities for the Corporation"* (page16).
- Annual reports are an excellent place to read about management strategy. BPCL's FY07 (https://goo.gl/m80Fg6) annual report spoke of succession planning, which is commendable considering that the company is a PSE. On page 13, the annual report states, *"BPCL has been striving to enhance its performance in all sectors of operations. It is also putting in place proper mechanisms to ensure smooth succession planning and proper manning across the organisation. The leadership pipeline for the organisation is being developed after a detailed analysis on the key variables of leadership effectiveness including organisational climate, personal characteristics, leadership styles and job requirements."*
- We find BPCL's discussion on global crude oil prices more detailed compared to other OMCs, both in quantity and quality. In their FY16 annual reports, while IOC (https://goo.gl/4lqwak) spent just about a page on the global economy, BPCL (https://goo.gl/l54uFr) dedicated four pages to explaining the tumultuous year for the world economy in general and crude oil in specific. However, we highlight that BPCL has been frank enough to admit that lower crude prices could be detrimental to the company, *"While lower crude prices have indicated enhanced profitability for the downstream Oil Companies in India, it also poses the concern of viability of investments in the upstream sector. Revisiting the investment decisions and validating the earlier choices has been a critical evaluation. Though the current prices continue to support BPCL's investments in the upstream sector, any further extreme decline in prices may prove to be detrimental."* (page 53)

3. Bajaj Finance

Bajaj Finance (BFL) has transformed from primarily being a captive financier for Bajaj Auto's two-wheelers to a much larger and diversified NBFC. Alongside this growth, BFL has also raised its disclosure standards. Bajaj Auto has a track record of impressive annual reports and BFL continues this tradition. BFL's annual reports, along with the quarterly reports, are among the best in the BFSI sector and an example for great investor communication.

Bajaj Finance's annual reports are among the best in the BFSI sector

- From its days of being mainly a two-wheeler and consumer durables financier, BFL has given segment-wise loans though this was not required under any law. Page 7 of its FY07 annual report provides the breakup of disbursals under automobiles, consumer durables, personal computers, and personal loans.

Nearly a decade later, in its FY16 annual report (https://goo.gl/MV4q2H), BFL continued this practice of disclosure when it gave the AUMs of its various businesses, namely, consumer lending, SME lending, commercial lending, and rural lending.

- As the business grew, BFL also stepped up the disclosures. The FY16 annual report has detailed write-ups on each segment. On its consumer lending business, the annual report states: *"BFL has over the years expanded its consumer durable financing to digital products and lifestyle products. It has tied up with leading manufacturers like Apple, Sony, Samsung, Dell, OPPO, Vivo among others for its digital products financing. It operates lifestyle products financing (for furniture, home furnishings, etc.) and digital product financing nation–wide in approximately 6,400 dealer counters. The combined growth in deployment of digital and lifestyle financing in FY2016 was 99%."* [page11]
- BFL has remained candid in tough years as well. The FY08 annual report (https://goo.gl/mYm4JX) provided the following explanation for the fall in profits and gave a grim outlook for the future as well, *"The year 2007-08 was a tough year for the industry in general and BAFL in particular. In 2007-08, owing to changes in external environment, the two-wheeler industry reduced its subvention offers to finance companies. BAFL suffered significantly, in its revenue and income growth due to this changed external scenario. Coupled with that, there was also a large increase in provision for doubtful debts and bad debts written off due to company's increased focus in semi-urban and rural markets in the last 2-3 years. Given the market environment in the retail finance industry, the company expects the current provisioning and bad debts trend to prevail in the near term."* [page 6]
- Finally, we like that management admitted to facing tough competition and changing its approach while focusing on ROE. In the FY16 annual report, the company stated, *"Secured SME lending continued to be in a hyper–competitive state throughout FY2016 as it was a year earlier, with loan sourcing being dominated by various intermediaries. During the year, BFL transitioned its retail mortgage business to a 100% 'Direct to Customer' model — in order to benefit from lower costs and create sustainable return on equity. As part of this strategy, BFL, henceforth, will only sell to its large existing customer franchise. While the transition resulted in some de–growth in business volumes during this year, it should deliver higher growth and better financials from next fiscal."* [page 12]

4. Shree Cement

Shree Cement produces the best annual reports in the Indian cement sector

Shree Cement has a track record of printing what, in our opinion, is the best annual report in the Indian cement sector. In its FY16 annual report (https://goo.gl/EeRiTt), Shree Cement follows its tradition of detailing how it is building competitive advantages, focusing on core strengths, and maintaining a strict discipline financially.

- The annual report is a 231 page document, which starts with exhaustive commentary from top management (Chairman, Managing Director, Joint Managing Director, President (Marketing), and President (Works)). We do not normally see such extensive communication from a company's leadership in annual reports since in most Indian companies the Chairman/MD/CEO hogs most of the attention.
- The annual report has a theme, 'Less is more'. The company's corporate philosophy is explained in detail (pages 10 and 11) and more than 40 pages (pages 20-62) emphasising Shree Cement's strategy on specific areas of conservation, efficiency, innovation, marketing, finance, human resources and CSR.

We reproduce extracts from the annual report that stood out for us:

On core competency: *"Specialisation in an exclusive cuisine is always better than having an ordinary menu of multiple cuisines. That's why at Shree, we deal in Cement and Power businesses only. We want to remain focused on lesser areas to achieve better results."* [Page 13]

On corporate culture: *"People and Time are two of the most important resources. A typical management theory is to have more meetings among people. More meetings, however, prove to be a major productivity killer. At Shree, we make our meetings truly count, and cut back on them wherever we can."* [Page 15]

On competitive advantage:

- **Innovations:** (a) in raw material use – *"the first Indian company to start using synthetic gypsum and bed-ash/fly-ash instead of gypsum in power plant"* (pg19) (b) *"reduced margins of heat losses and made the Waste Heat Recovery (WHR) systems, one of the most effective amongst Indian cement companies, (c) changed aerofoils to averaging pilot tube which reduced air flow pressure drop by 90% and installed twin lobe blower system to reduce power consumption further."* [Pages 4 and 33]
- **Distribution**: *"We were among the first companies to embark on the hub and spoke model, setting up Cement Grinding Units nearer to fly-ash sources and consuming markets. This approach not only made us competitive by reducing our costs but also helped us garner higher market share through reduced lead time."* [page 16]

On Financial discipline: *"At Shree, financial discipline has been the pillar on which growth has been planned. Irrespective of the external environment, Shree has never drifted away from its principle of stretching only to the extent which its available financial means could support. The Company has planned its growth in its own way without giving in to the temptation of leveraged opportunities during times of abundant liquidity and hence not getting impacted during times of stretched financial market conditions. This has helped it survive the fluctuations in the external environment and navigate its way through it."* [Page 53]

5. Marico

Marico, which is a part of "The Unusual Billionaires", is another company that has consistently high standards of commentary and disclosure. Marico's MDA is typically a 20-pager document that focuses on many aspects in detail and explaining management's strategy on various aspects. In particular, we like Marico's focus on employee culture and capital allocation, both of which get prime coverage every year.

We like Marico's focus on employee culture and capital allocation

Employee culture:

FY13 (https://goo.gl/lGcpKM)**:** *"Marico firmly believes that "Culture drives business". As the custodian as well as the facilitator of Marico's values and culture, HR defines people, processes, policies, and practices that drive results and enable profitable growth. Marico's culture has helped in driving sustainable profitable growth over years now."* (Page 8)

FY14 (https://goo.gl/sFgazw)**:** *"The mission of the HR Function at Marico is to partner business and attract and nurture talent to succeed. The HR function is also the custodian of Marico's culture and governance standards."* (Page 24)

FY15 (https://goo.gl/gwsaVr)**:** *"The HR function's Mission is to 'attract and nurture talent to succeed' for Marico to achieve its business aspiration. The Company strives to achieve this by continuously providing opportunities to challenge, enrich, and fulfill the aspirations of Mariconians so that they can maximise their true potential. The HR function is also the custodian of Marico's culture and governance standards."* (Page 18)

FY16 (https://goo.gl/3BBPfK)**:** *"Talent and Culture are two strategic drivers for Marico to achieve its business aspiration of becoming an emerging market multinational. The HR Function's mission has been to attract and nurture talent to succeed and create a great place to work."* (Page 54)

The results of Marico's efforts are evident in the fact that it was ranked #3 in the FMCG industry in the 2015 'Great Place to Work' Study and #4 in the 2014 Aon Hewitt Top Companies for Leaders in India. Moreover, as we have explained at length in our book, The Unusual Billionaires, Marico's unique work culture puts it on par with larger MNC FMCG companies like HUL and Nestle, making it an employer of choice.

Financial discipline: Marico has a section in its MDA dedicated to capital utilisation and it has followed this practice for many years. This section focuses mainly on explaining the trends in return on capital employed (ROCE) from year to year, followed by shareholder value and dividend policy. In particular, we like the shift in policy towards returning excess cash to the shareholders and consciously raising dividend payout ratio:

FY13 (https://goo.gl/rZoNii)**:** *"Your company will periodically review the need for cash and may revise the payout ratio upwards in case it does not find any suitable avenue to deploy internal cash accruals other than dividends."* (page 20)

FY14 (https://goo.gl/8wPwVW)**:** *"The Company will endeavor to improve the dividend payout ratio further depending on the acquisition pipeline."* (page 24)

FY15 (https://goo.gl/iSHXKm)**:** *"The Company will endeavour to improve the dividend payout ratio further depending on its fund requirements for organic and inorganic growth."* (page 18)

FY16 (https://goo.gl/c1LUx7)**:** *"Subject to its fund requirements towards inorganic growth, the Company shall endeavour to maintain a dividend payout ratio of 40-50% in the medium term."* (page 54)

6. Balrampur Chini

Promoters that are committed to high standards of corporate governance aren't restricted to large-cap companies

Balrampur Chini (BRCM) is another company whose annual reports have remained consistently impressive over the years. BRCM is also an example of how promoters that are committed to high standards of corporate governance aren't restricted to large-cap companies.

Unlike secular growth sectors like consumer goods, IT, cars, etc., the sugar industry is cyclical, dependent on factors such as global sugar prices, government policies, monsoons, etc. Thus, it is easy for promoters to blame their woes on extraneous factors. However, BRCM comes across as a refreshing case of the promoter consistently focusing on the importance of strong financials, corporate governance, and operational excellence. We highlight the following:

- As far back as FY02 (https://goo.gl/NdOyYB), BRCM wrote lucidly on focusing on its core business and maintaining financial discipline. This is a quote from page 2 of the FY02 annual report: *"The better-than-industry average return reported by Balrampur in 2001-02 is the result of years of prudent asset creation in regulated markets. As a policy during these times, Balrampur expanded cautiously but consistently. For instance, Balrampur expanded incrementally, never adventurously. Balrampur funded growth through accruals and debt, never either. Balrampur raised debt at the lowest possible cost."* The FY02 annual report also contained a 13-page supplement on the opportunities and implications of the government's proposal to blend ethanol with gasoline.
- For the first time in its history, BRCM reported an operating loss in FY07 (https://goo.gl/zcXAzx) following a decline in sugar prices and rise in raw material costs. BRCM was frank and open in discussing the reasons behind the loss. On page 15 of the annual report, Managing Director, Mr. Vivek Saraogi, said *"We have for the last number of years complained that raw material prices in Uttar Pradesh were higher than the rest of the country, resulting in a muted profitability for the millers. This request – or you can call it appeal – fell on deaf ears. However, what transpired during 2006-07 was completely unprecedented; even as the country was sitting on a large sugar surplus that caused realisations to be depressed, the raw material prices were maintained at a really prohibitive level of around Rs125 per quintal. The result was that all the patient initiatives that we had invested in strengthening our business model down the years went down the tube in a flash. At one point during the financial year under review, the Company*

was not even recovering its raw material cost, forget the conversion cost, the interest burden and overheads."

- In FY16 (https://goo.gl/1efwzn), a year of turnaround, the company admitted that higher realisations were instrumental in the recovery but also highlighted its own efforts on page 14: *"It comprises the replacement of high-cost debt with cheaper alternatives, focus to improve sugar recovery, quality, consumption of entire molasses for ethanol production and reporting energy savings to enhance bagasse availability, among others.[..]We create captive downstream capacities to utilise the entire bagasse and molasses generated through cane crushing. We produce more ethanol for government OMCs to enhance fiscal stability."* [Page 14]
- Finally, in the FY16 (https://goo.gl/c4qmEf) annual report, BRCM effectively communicated its objectives ("Our aspiration is to sustain our position as one of the most efficient and profitable Indian sugar companies across business cycles.") and the principles that define its conduct, namely: "One, over the years, we have stuck to our core competence: the efficient manufacture of sugar on the one hand and the planned integration into the processing of downstream byproducts on the other. Two, we kept leverage under control, retained bankers' confidence and stayed away from the temptation of unrelated diversifications. Three, while it would be evident that we remained conservative, the reality is that within this conservatism we redefined our dynamism." [Page 15]

Benefits of clear communication

There are many benefits to companies when it communicates clearly to shareholders via annual reports, quarterly conference calls, quarterly reports, presentations, etc. Apart from achieving higher standards of corporate governance, promoters will also benefit when the investors in their company have a better understanding of their business.

Promoters benefit when investors in their company have a better understanding of their business

In their book, *'The end of accounting'*, authors Baruch Lev and Feng Gu of Gavekal Research argue[10] that backward-looking accounting statements say little about an enterprise's future growth and ability to compete. Hence, the remedy of the corporate earnings problem lies in the systematic disclosure of information that focuses on the fundamentals of the business. They provide the following example of Netflix's results:

- *When Netflix's quarterly earnings announcement in April fell short of the consensus estimate of analysts, its share price surprisingly rose almost 18% on the announcement. An investor blackout? No. Investors justifiably ignored the backward-looking accounting information, reacting enthusiastically to a sharp rise in the forward-looking new-subscribers indicator: 4.9 million vs. expected 4 million. Furthermore, astute investors noticed that a major reason for the earnings shortfall was Netflix's large investment in future growth—technology development; 9% of sales—which accountants expense in the income statement.*

Thus, great annual reports make for high standards of corporate governance and better appreciation of the business by investors, which eventually help in financial performance being better reflected in the stock price. Great annual reports would, therefore, be beneficial to both investors and promoters given that their wealth is collectively tied to the stock price performance of the listed business.

Great annual reports are beneficial to both investors and promoters

[10] http://www.wsj.com/articles/the-end-of-accounting-1466529229

Section 3: Checklist for a great annual report

"When writing Berkshire Hathaway's annual report, I pretend that I'm talking to my sisters."

- Warren Buffett in an SEC handbook (1998)

Rules for a great annual report

Based on our learnings from the great annual reports mentioned in the case studies in Section 2, we prepare a checklist for writing a good annual report. We believe promoters should keep the following ground rules in mind:

- Promoters should communicate the long-term objectives of their business, and the strategies to achieve them, clearly to their shareholders.
- This communication involves exhaustive disclosures and transparency, both of which are part of high corporate governance standards. Hence, promoters should go beyond the ambit of mandatory disclosures in the annual report.
- In the same vein, promoters should discuss key issues with candor in the non-mandatory section.

Promoters should communicate objectives and strategies of their business clearly to shareholders

Using these rules we provide an indicative flowchart of a great annual report in the exhibit below. Detailed communication, including data on financial and operational performance, which is placed before the annual accounts, should ideally be in the first section of the annual report. For example, BRCM's FY02 annual report contained a discussion on ethanol blending between the director's report and MDA. The discussion on 'Project Leap' in Bharti's annual report came directly after the letters from the Chairman and senior management.

Detailed communication should ideally be in this first section of the annual report.

Exhibit 1: Content layout of an annual report

Section	Tips
Statement of objectives	Include key strategies to achieve them.
Corporate profile	Description of various divisions of businesses.
Financial Trends	5 to 10 year trends on important financial, operational parameters.
Chairman's letter	Clear, concise, succinct commentary not showmanship.
CEO and senior leadership letters	Achievements, failures, strategy and outlook for the future.
Director's report	Summary of the year gone by in clear words; can be expanded in MDA.
MDA	Comprehensive, clear summary of the year, sticking to company-specific achievements, putting things in perspective and providing an outlook for the future. Discuss near-term and long-term performance trends.
Annual accounts	Go beyond mandatory disclosures, giving important company-specific financial data that helps investors understand the business better.

Source: Ambit Capital research

How to spot a great annual report

Disclosure levels in Indian annual reports have improved over the years, with introduction of consolidated accounts, segmental information, etc. In August 2012, SEBI[11] made business responsibility reporting requirement compulsory for top 100 listed entities based on market capitalisation in their annual reports. In 2015, this was extended to the Top 500 companies. Thus, over the years, the scope of annual reports has been expanded and disclosure levels have improved, compared to the past. Companies complying by these norms would, obviously, adhere to minimum corporate governance standards.

[11] http://timesofindia.indiatimes.com/business/india-business/Business-responsibility-reports-must-for-top-500-listed-companies-Sebi/articleshow/49987154.cms

Our checklist in Exhibit 2, however, is for companies that want to exceed these corporate governance standards. How do they achieve this? By disclosing data beyond legal requirements and discussing, frankly, how the company is achieving its corporate objectives every year.

Exhibit 2: How to spot a great annual report

Aspect	Great annual reports	Mediocre annual reports
Additional financial information	Data that is relevant to a shareholder.	Either ignores extra disclosures or provides irrelevant detail to divert attention.
Candour on capital allocation	Will talk about ROCEs, shareholder policies, etc.	Will focus on topline, large capex for building empire, etc.
Clarity on objectives	Contains objectives, vision, missions, goals, and strategy to achieve them.	Silent on objectives.
Corporate strategy	Will specify competitive advantages and how they are building them.	No intelligent reasoning given for major strategic initiatives.
Employees and work culture	Will disclose data on hiring, attrition and strategy for building employee culture.	Will cursorily mention state of relations with labour and staff.
Language	Will use specific, measurable, achievable, realistic, time-bound (SMART) goals.	Vague goals backed by overarching ambitions.
Recent performance	Detailed, frank discussion on recent performance and admission of failure.	Omits this discussion or blames failure on global/macro trends
Top management views	Comprehensive letters from senior leadership.	Chairman's letter which is typically a brief summary of the year gone by.

Source: Ambit Capital research

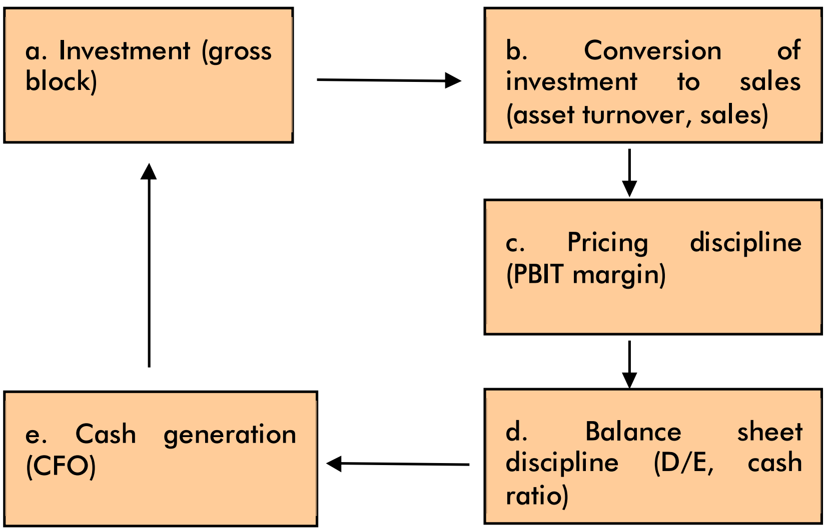
We believe that promoters who take this extra step of clear communication with shareholders every year, will land up in ensuring higher standards of corporate governance than hiring a stellar board of directors for ensuring the same objective.

Where to look for great annual reports?

Having identified the specific traits of great annual reports, we address the next logical question – where to start looking for these great annual reports? We offer a simple screener using our proprietary 'greatness' and 'forensic' models.

- Our **greatness** model allows us to identify structurally sound businesses in India that are not just improving but also show consistency in improvement over a six-year cycle. The following exhibit demonstrates how our 'greatness' framework works:

Exhibit 3: The 'greatness' framework



Source: Ambit Capital research

- Over the past six years, **forensic accounting** has played a crucial role in shaping our investment philosophy as we have time and again highlighted the vitality of accounting quality in shaping investment returns. Please *click here* for our 17 December 2015 thematic, "Forensic Accounting: Are you in the Zone of Darkness?", where we discussed how accounting quality plays an important role in shaping investment returns.

Thus our accounting model helps us steer clear of firms with sub-par accounting and our greatness model allows us to identify structurally sound businesses in India that are not just improving but also show consistency in improvement over a six-year cycle.

In the wake of several clients requesting access to both our 'forensic' and 'greatness' models, two weeks ago we launched our 'HAWK' platform wherein we gave clients access to Ambit's proprietary 'forensic accounting' and 'greatness' models in an easy to use and intuitive format (*click here* to view the product and *here* for the User Guide).

Using the above filters, we provide a list of 50 companies, consisting of 25 companies from the S&P BSE500 Index and another 25 from the small cap universe. We believe these companies are a good starting point for investors looking to spot great annual reports using the checklist provided by us in this section.

Exhibit 4: Top 25 companies (ex BFSI) from BSE-500 based on our greatness and forensic frameworks

Company Name	Ticker	Market Cap (US$ mn)	Ambit Rating	Accounting Decile	Greatness Score
ITC	ITC IN	43,708	BUY	D1	83%
Hind. Unilever	HUVR IN	27,971	BUY	D2	83%
HCL Technologies	HCLT IN	17,325	BUY	D2	92%
Britannia Inds.	BRIT IN	6,283	SELL	D2	83%
Idea Cellular	IDEA IN	4,389	NR	D1	92%
GlaxoSmith C H L	SKB IN	3,891	SELL	D2	83%
P & G Hygiene	PG IN	3,372	NR	D3	92%
Page Industries	PAG IN	2,625	BUY	D3	88%
Rajesh Exports	RJEX IN	2,082	NR	D1	71%
Alembic Pharma	ALPM IN	1,877	NR	D1	79%
Supreme Inds.	SI IN	1,767	BUY	D1	83%
P I Inds.	PI IN	1,734	BUY	D2	92%
Tube Investments	TI IN	1,703	NR	D1	75%
Kajaria Ceramics	KJC IN	1,672	NR	D1	92%
Guj Pipavav Port	GPPV IN	1,298	NR	D1	83%
KRBL	KRB IN	915	NR	D4	100%
Relaxo Footwear	RLXF IN	836	NR	D1	92%
Persistent Sys	PSYS IN	802	SELL	D1	100%
Tata Elxsi	TELX IN	661	NR	D1	83%
DCM Shriram	DCMS IN	518	NR	D1	71%
Greenply Inds.	MTLM IN	495	NR	D2	79%
La Opala RG	LOG IN	449	NR	D3	92%
Himatsing. Seide	HSS IN	428	NR	D1	83%
Trident	TRID IN	401	NR	D1	100%
Suven Life Scie.	SVLS IN	383	NR	D1	100%

Source: Bloomberg, Ambit Capital research

Exhibit 5: Top 25 companies (ex BFSI) from outside BSE-500 based on our greatness and forensic frameworks

Company Name	Ticker	Market Cap (US$ mn)	Ambit Rating	Accounting Decile	Greatness Score
Avanti Feeds	AVNT IN	362	NR	D2	92%
Guj Alkalies	GALK IN	346	NR	D1	83%
Heritage Foods	HTFL IN	317	NR	D2	92%
Kitex Garments	KTG IN	315	NR	D2	79%
T.V. Today Netw.	TVTN IN	277	NR	D1	67%
Poly Medicure	PLM IN	253	NR	D2	92%
Fiem Inds.	FIEM IN	230	NR	D1	92%
Atul Auto	ATA IN	162	NR	D1	100%
RSWM Ltd	RJS IN	157	NR	D1	92%
Kovai Medical	KMC IN	134	NR	D1	92%
Nandan Denim	NAND IN	99	NR	D2	92%
Alkyl Amines	AACL IN	96	NR	D2	96%
Adi Finechem	ADFI IN	91	NR	D1	92%
Nahar Spinning	NSM IN	70	NR	D1	79%
Shirpur Gold	ATRI IN	68	NR	D1	88%
Sreeleathers	SREE IN	66	NR	D1	83%
Cupid	CUPD IN	50	NR	D1	83%
Nitin Spinners	NSPL IN	49	NR	D1	79%
Multibase India	MUIL IN	47	NR	D1	83%
K G Denim	KGD IN	35	NR	D1	83%
Ruchira Papers	RUCP IN	30	NR	D1	88%
Paushak	PAUS IN	29	NR	D1	83%
Benares Hotels	BHL IN	22	NR	D1	83%
APM Inds.	APM IN	22	NR	D1	83%
Fluidomat	FDM IN	14	NR	D1	88%

Source: Bloomberg, Ambit Capital research

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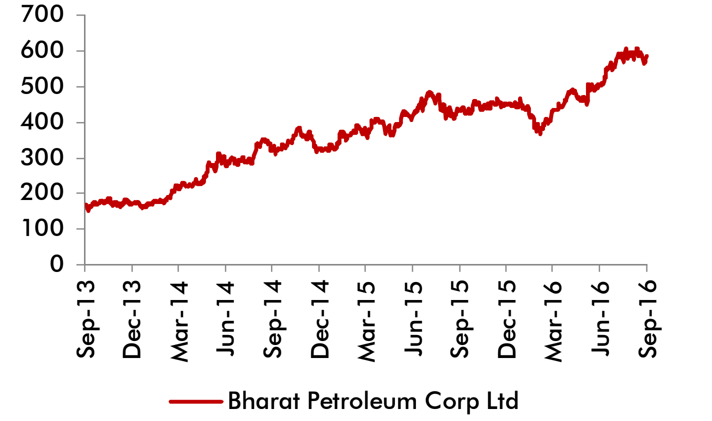
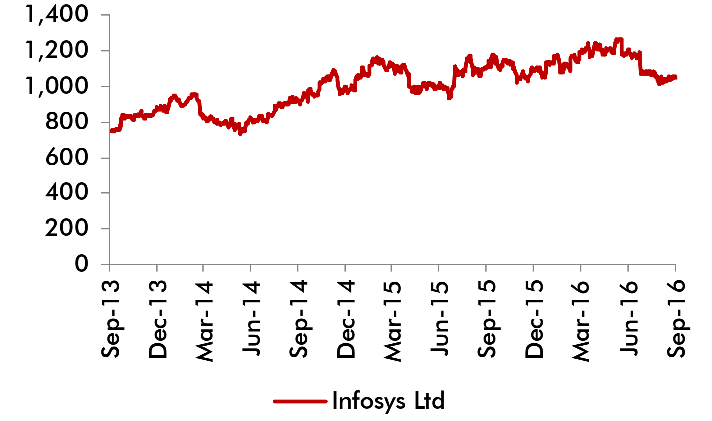
Bharat Petroleum Corp Ltd (BPCL IN, BUY)



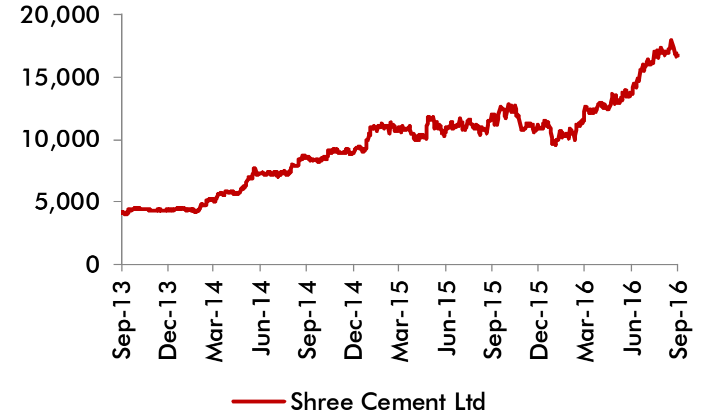
Source: Bloomberg, Ambit Capital research

Infosys Ltd (INFO IN, BUY)



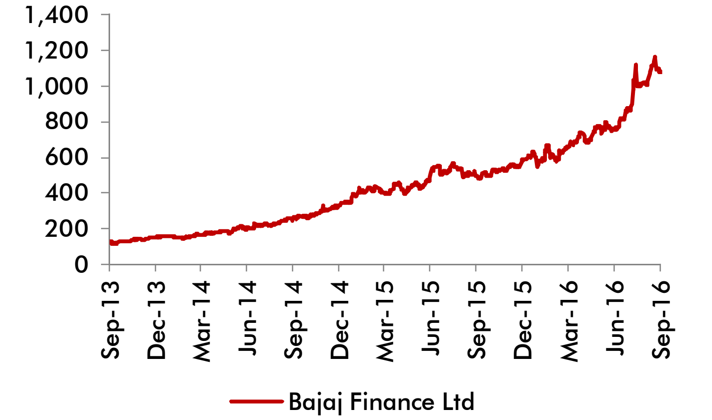
Source: Bloomberg, Ambit Capital research

Shree Cement Ltd (SRCM IN, SELL)



Source: Bloomberg, Ambit Capital research

Bajaj Finance Ltd (BAF IN, SELL)

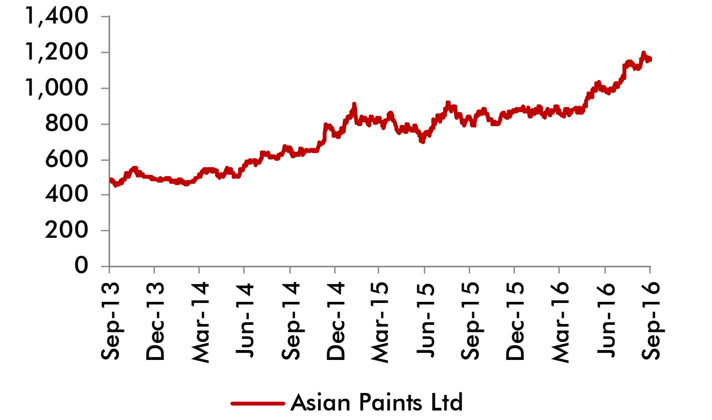


Source: Bloomberg, Ambit Capital research

Marico Ltd (MRCO IN, BUY)

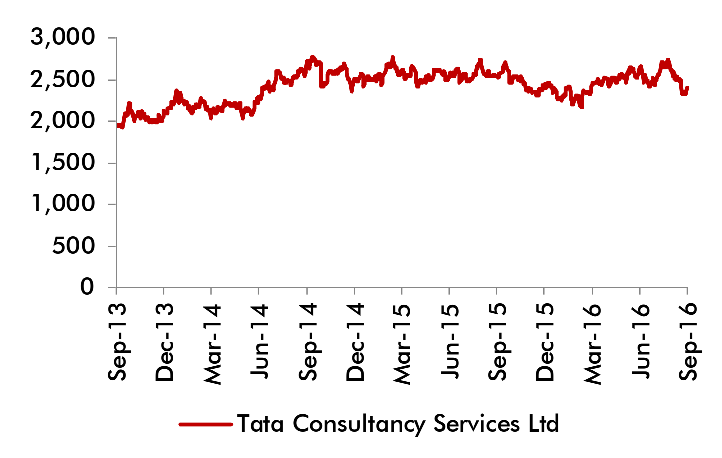
Source: Bloomberg, Ambit Capital research

Asian Paints Ltd (APNT IN, BUY)



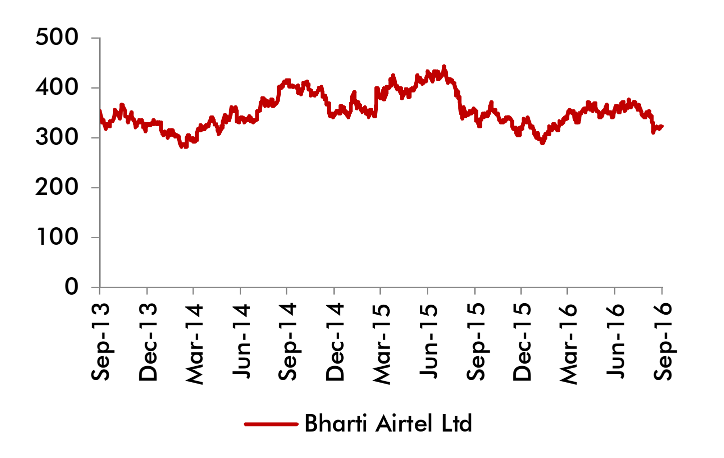
Source: Bloomberg, Ambit Capital research

Tata Consultancy Svcs Ltd (TCS IN, BUY)



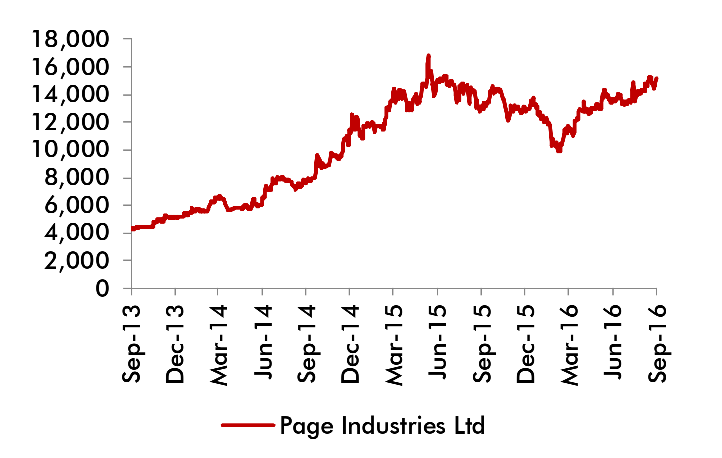
Source: Bloomberg, Ambit Capital research

Bharti Airtel Ltd (BHARTI IN, NOT RATED)



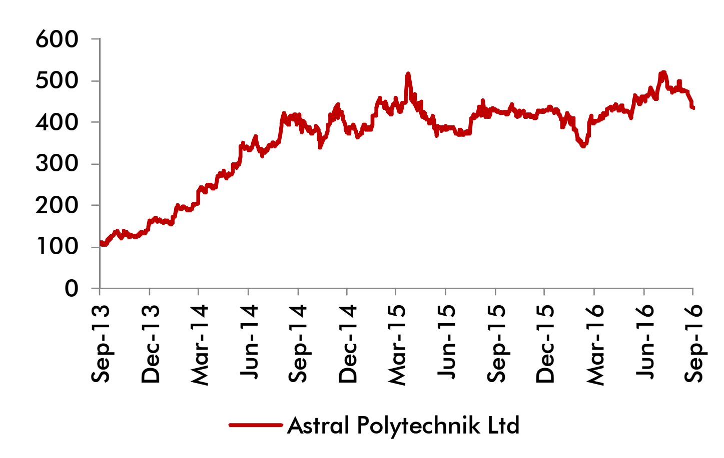
Source: Bloomberg, Ambit Capital research

Page Industries Ltd (PAG IN, BUY)



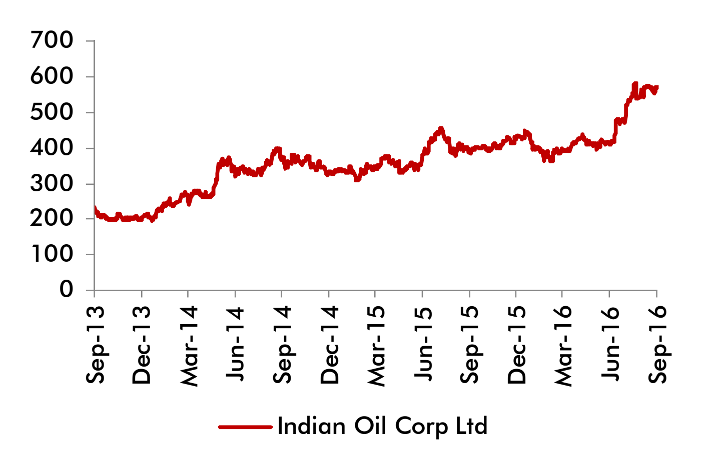
Source: Bloomberg, Ambit Capital research

Astral Poly Technik Ltd (ASTRA IN, NOT RATED)



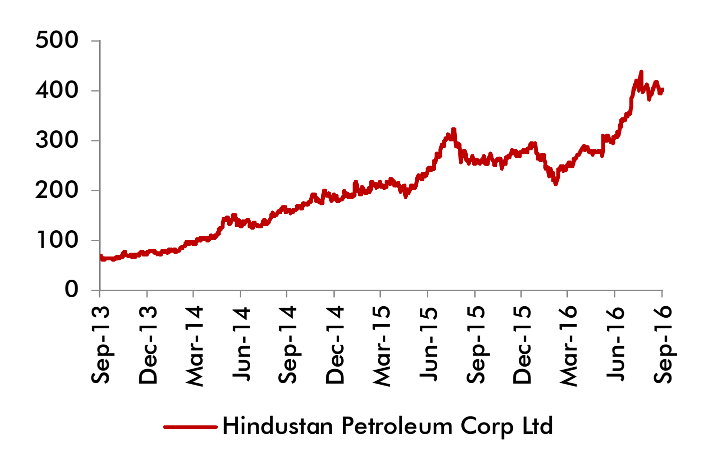
Source: Bloomberg, Ambit Capital research

Indian Oil Corp Ltd (IOCL IN, BUY)



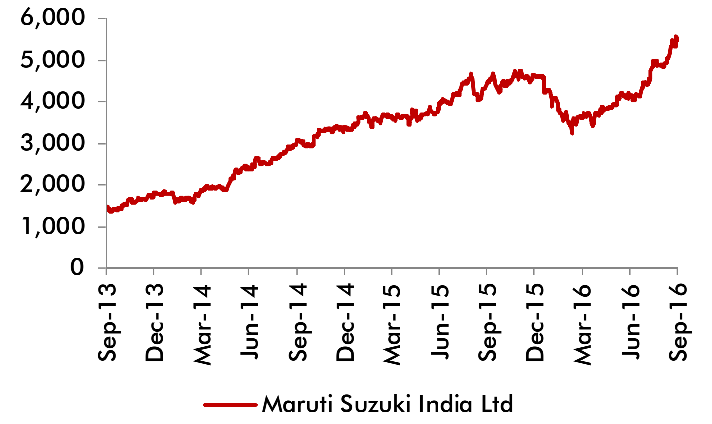
Source: Bloomberg, Ambit Capital research

Hindustan Petroleum Corp (HPCL IN, SELL)



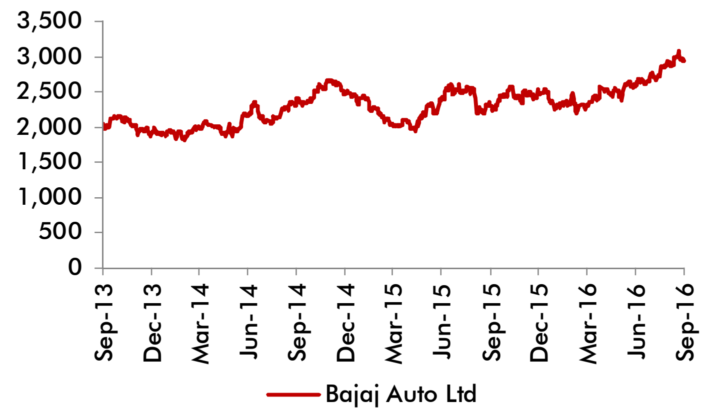
Source: Bloomberg, Ambit Capital research

Maruti Suzuki India Ltd (MSIL IN, SELL)



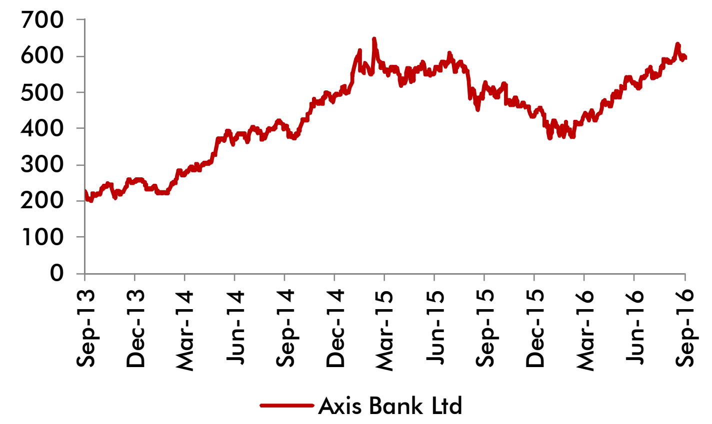
Source: Bloomberg, Ambit Capital research

Bajaj Auto Ltd (BJAUT IN, SELL)



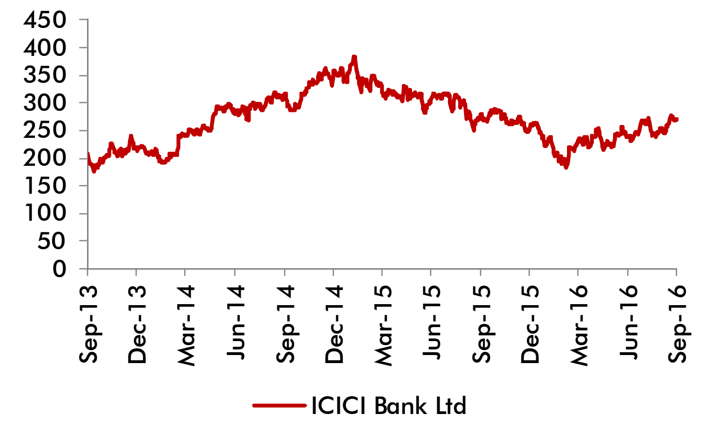
Source: Bloomberg, Ambit Capital research

Axis Bank Ltd (AXSB IN, BUY)



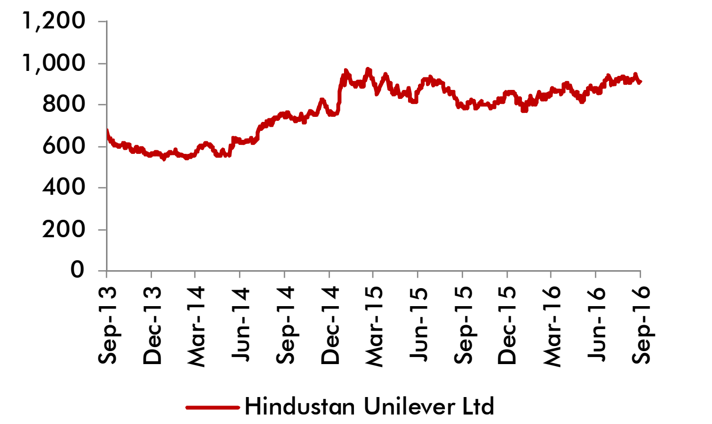
Source: Bloomberg, Ambit Capital research

ICICI Bank Ltd (ICICI IN, SELL)



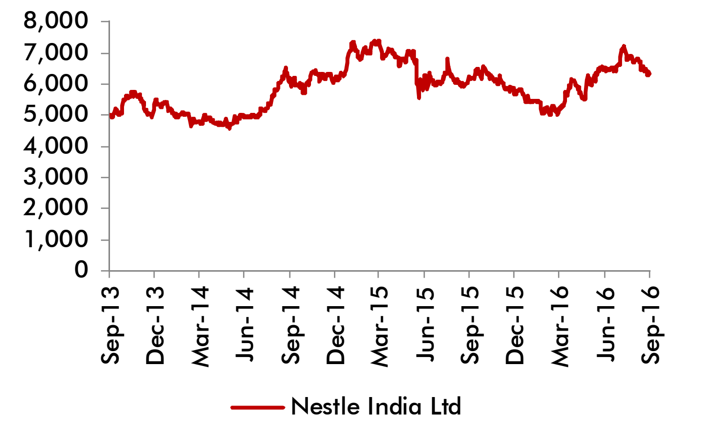
Source: Bloomberg, Ambit Capital research

Hindustan Unilever Ltd (HUVR IN, BUY)



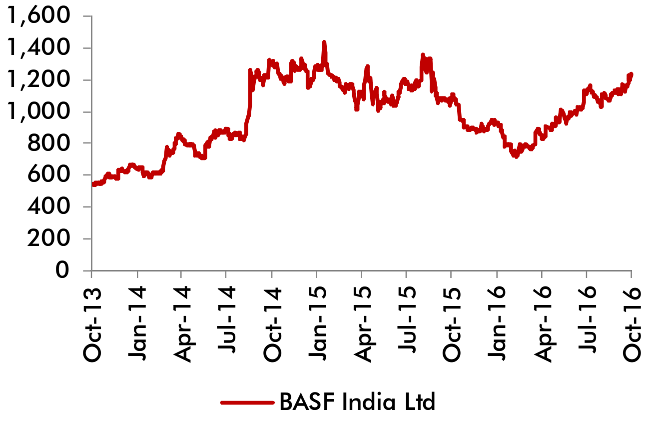
Source: Bloomberg, Ambit Capital research

Nestle India Ltd (NEST IN, SELL)



Source: Bloomberg, Ambit Capital research

BASF India Ltd (BASF IN, NOT RATED)



Source: Bloomberg, Ambit Capital research

Balrampur Chini Mills Ltd (BRCM IN, NOT RATED)

Source: Bloomberg, Ambit Capital research

Explanation of Investment Rating

Investment Rating	Expected return (over 12-month)
BUY	>10%
SELL	≤10%
NO STANCE	We have forward looking estimates for the stock but we refrain from assigning valuation and recommendation
UNDER REVIEW	We will revisit our recommendation, valuation and estimates on the stock following recent events
NOT RATED	We do not have any forward looking estimates, valuation or recommendation for the stock
POSITIVE	We have a positive view on the sector and most of stocks under our coverage in the sector are BUYs
NEGATIVE	We have a negative view on the sector and most of stocks under our coverage in the sector are SELLs

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