Corporate India in Focus as Adani hits the Buffers

India's Adani Enterprises, which scripted a somewhat unprecedented 'growth story' that invited both awe and occasional scorn, found the ground sinking beneath its feet last week as a US research firm's damning account of the meteoric rise in the share prices of the conglomerate and its group companies unnerved investors. The report from Hindenburg Research – a firm specialising in shorting stocks – raises issues that are extremely complex in nature and strikes at the heart of parts of corporate India.

From our perspective, the close to 1400% surge in Adani Enterprise's share price over the past three years is very difficult to justify. Hence, in our view, the stock is vulnerable to further substantial downside despite last week's 21% fall. While the report alleges significant manipulations on part of the Adani Group, lack of transparency and poor corporate governance in family-dominated businesses are two of the more important ones that require attention.

It is difficult to overstate the importance of Adani Group to the Indian economy and India's financial markets. The ambition of the Modi government to transform India into a modern republic will require massive investments, which will, in part, be enabled by companies such as Adani Enterprises. But if that transformation requires foreign capital, then the Indian corporate sector will have to increasingly abide by international corporate governance and regulatory norms.

Here, it'll be interesting to quote an excerpt from an Oxfam India report released about a year ago. *"Oxfam India's new Inequality Report released on 17 January 2022 has highlighted that in India, while 84 per cent of households suffered a decline in their income in a year marked by tremendous loss of life and livelihoods, the number of Indian billionaires grew from 102 to 142, and the collective wealth of India's 100 richest people hit a record high of INR 57.3 lakh crore (USD 775 billion) in 2021. What is more, the report points out, about one-fifth of the increase in the rise of the richest 100 families was accounted for by the very fast pace of the wealth of a single business house—the Adani's of Gautam Adani fame—whose net worth and wealth increased by several times since the advent of the pandemic."*

Our purpose is not to demonise anyone but only to reflect on the structure of corporate India and how a potential shift in power away from the dominance of families such as the Adanis will alter the perception of corporate India and Indian asset markets.
We must recognise that India's history and culture are firmly based on family and community. The Economic Times, the business-focussed daily newspaper, estimates that family businesses account for 70% of India's GDP. To quote KR Sekar of Delloite India (Economic Times, October 2021), *"Without family businesses, Indian businesses will fail because it not only contributes to the GDP, it is also the biggest creator of employment generation".* We agree that family businesses are crucial for employment growth given their dominance in Indian corporate life. But such statistics do not prove that the dominance of family businesses is the most effective or efficient corporate structure to ensure India's strong, enduring, high-quality GDP or employment growth.

The Hindenburg report, which the firm claims is based on two years of research, is scathing in its conclusion as it notes, *"We have uncovered evidence of brazen accounting fraud, stock manipulation and money laundering at Adani, taking place over the course of decades. Adani has pulled off this gargantuan feat with the help of enablers in government and a cottage industry of international companies that facilitate these activities."*

Below we break down the issues into substantive takeaways that are likely to be the focus of investors in the coming weeks and months now that Hindenburg has laid down the gauntlet.

Family business – the good and the not so good
Research on family businesses and their effectiveness as a corporate structure for growth and development of a country is an industry in itself, and we have too little time here to provide well-argued substantive opinions. The Hindenburg report has many sections highlighting, in particular, the downside of family businesses. However, if we try pulling out one strand of thought that, in our view, will be paramount, it would be that for a company of Adani Enterprise's size, it's a real stretch to believe that family members alone should have such seemingly unfettered control over the business. The issue is corporate governance. If a company of this scale wants to take money from the public to build its business, it must abide by the rules. It must be transparently working to the benefit of all shareholders, and to this end, it needs to have more independent voices in its corporate structure.

Transparency
The report makes several allegations of a lack of transparency and disclosure of the holdings of Adani Group company shares by related parties. By way of background, where greater than 75% of an Indian-listed company is owned by one entity, the company would ordinarily be forced to delist. Hindenburg alleges that Adani-related entities may hold shares that take the related parties past the 75% threshold. Also, Hindenburg's research has unearthed a web of companies owning only shares in Adani entities and often based in Mauritius. The concern is that these entities may be engaged in share price manipulation.

The Mauritius investment fund regime has been perennially under scrutiny by global regulators. It has been a particular problem for the Indian regulators, given the closeness of the two countries and the tax advantages that have been afforded to Indian nationals from transacting through Mauritius. The Hindenburg report will only highlight those challenges once again.

High borrowings
The report alleges that many Adani companies have excessive borrowings relative to their profitability and industry norms (Table 1). Also, four of the seven group companies have ongoing free cash outflow issues. The data they present is below. The current ratio, compares a company's short-term assets to short-term liabilities; a current ratio below 1.0 can indicate that a company may struggle to fund its near-term cash needs.

Table 1: Debt ratios of the Adani Group companies

Name	Net Debt/ EBITDA	Industry Avg.	Current Ratio	FCF (mil ₹)
Adani Green Energy	12.1x	6.3x	0.5	-146,850
Adani Power	3.3x	6.3x	0.9	71,527
Adani Total Gas	1.5x	4.1x	0.2	-2,383
Adani Transmission	9.1x	6.3x	0.8	-19,615
Adani Enterprises	6.4x	2.9x	0.7	-120,420
Adani Wilmar	1.9x	2.9x	1.2	3,886
Adani Ports	4.1x	1.3x	1.5	52,220

(Source: FactSet)

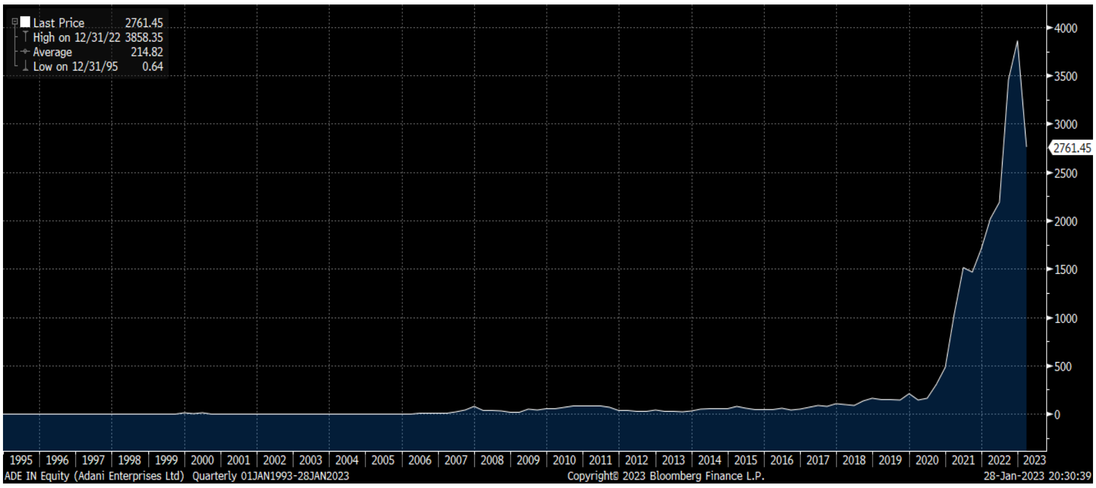
Source: Hindenburg

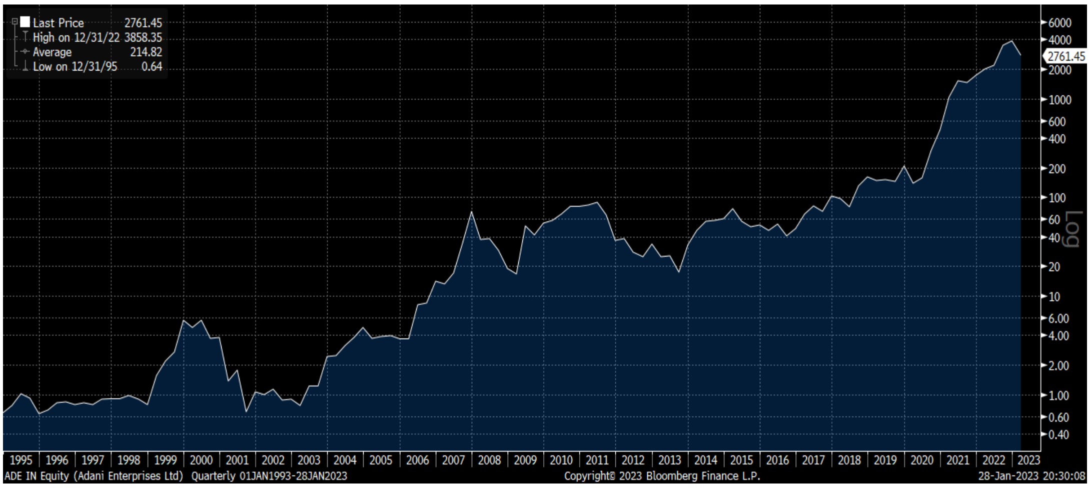
As far as corporate borrowings are concerned, there isn't a clear read-through that is available for corporate India and despite that vagueness Adani Group has been a special case. A recent Bank for International Settlements (BIS) study showed that the core debt of the Indian private non-financial sector fell to 87.8% of GDP between 2017 and June 2022 from 92.8% of GDP. The decline is mainly because of the reduction in debt levels of non-financial private corporations, which came down to 52.3% of GDP from 58.3% of GDP over the same period..

The Hindenburg report was the catalyst for further profit-taking in the Indian equity market and a significant correction in the Adani Enterprises' share price. The 30-share Sensex index fell 2.7% on the week, with Adani Enterprises plunging 20%. Shares in Adani Enterprises are now down 34% from their highs in December.

Below, Chart 1 (normal scale) and Chart 2 (log scale) show just how extraordinary the surge in the share price of Adani Enterprises has been. Chart 2 shows that the share price rise is not just a phenomenon of the past three years but that the pace of the share price rise has largely remained intact since 2002, with a marked acceleration in performance 2020 onwards.

Chart 1: Adani share price





The report is probably most compelling in questioning the sharp rise in the valuation of the parent company and its subsidiaries.

Table 2: Rise in share prices of Adani Group companies

Company Name	MCap (Mil INR)	MCap (Mil U.S $)	1-YR Stock % Gain	3-YR Stock % Gain
Adani Enterprises	3,928,558	48,108	101%	1398%
Adani Transmission	3,095,771	37,910	36%	729%
Adani Total Gas	4,275,567	52,357	118%	2121%
Adani Green Energy	3,047,678	37,321	4%	908%
Adani Power	1,062,201	13,007	167%	332%
Adani Ports	1,668,599	20,433	8%	98%
Adani Wilmar**	734,123	8,990	149%	149%
Total	17,812,498	218,127		

(Source: Bloomberg)
**Adani Wilmar performance is since February 2022 IPO

As Table 3 shows, the valuation of Adani companies is at odds with the industry averages, even accepting that the Adani Group is a good manager of assets. As demonstrated earlier in this commentary, many Adani businesses suffer free cashflow deficits. They are burdened with a heavy debt load in an environment of rising interest rates and challenging credit markets.

Table 3: Comparative valuation for Adani businesses way above industry norms

Name	Price/ Earnings	Industry Avg.	Implied Downside	Price/ Sales	Industry Avg.	Implied Downside	EV/ EBITDA	Industry Avg.	Implied Downside
Adani Green Energy	815x	24x	-97.10%	60.6x	1.1x	-98.13%	101x	12x	-88.33%
Adani Power	29x	24x	-18.17%	3.9x	1.1x	-70.66%	13x	12x	-10.42%
Adani Total Gas	831x	20x	-97.64%	139.3x	1.0x	-99.31%	303x	9x	-97.16%
Adani Transmission	312x	24x	-92.43%	27.3x	1.1x	-95.84%	69x	12x	-83.01%
Adani Enterprises	508x	12x	-97.68%	5.7x	0.5x	-91.33%	66x	8x	-88.16%
Adani Wilmar	90x	30x	-67.12%	1.3x	1.1x	-20.90%	37x	15x	-58.26%
Adani Ports	35x	2x	-93.26%	10.5x	0.9x	-91.65%	20x	2x	-88.07%

(Source: FactSet & Hindenburg analysis)

We have our doubts, too.

1. **Will the Adani Group be able to brush off the challenge and continue on its merry way?** We doubt it. There are just too many dimensions to the Hindenburg report. While we agree with the critics of the report that some of the material is a rehash of stories published earlier, what the report has achieved is to put all those issues together in one story. It leaves the reader thinking as to why the group has not been brought to account?
2. **Will the report have a broader impact on corporate governance in India?** We hope so. It would only be good news that corporate India decides to shape up to conform to the global rules of corporate governance. The quicker it adheres to the international standards; the faster broader sources of global finance will be made available to the country's corporate sector.
3. **Will some of the criticism of Adani undermine the effectiveness of Modi's government?** The Adani Group is at the front and centre of the government's efforts to transform India's infrastructure. The funding of those ambitions must come from more than just domestic sources. Hence, we expect the government to press the Adani Group to be at least cognisant of the criticisms and placate international investors.