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Observations on Quess Corp drawn from RHP and other publicly available sources

Some background

Quess is looking to offer its shares to the public soon and the shares are likely to be offered at a valuation of ₹ 30 billion as per news reports[1]. A few months ago the largest shareholder of Quess, Thomas Cook India Ltd (TCIL), also a listed company, decided to give away – after shareholders' approval, around 7% of its outstanding shares[17], at par as part of "*proposals to retain buy in of Mr Ajit Isaac*"[2] and in order to "*secure his full commitment to the Quess performance*" [2]. Mr Ajit Isaac (AI) is the co-founder and CEO of Quess. This transfer translates to a loss in value of ₹ 2.1 billion to TCIL owners at reported value. However barring a few retail shareholders TCIL got a thumping approval to the proposal[3]. SES, a proxy advisory firm, had recommended that shareholder vote against the proposal while putting the loss as high as ₹ 5 billion[4]. The CEO of Quess is well regarded in the industry and investment community at large[5,6,7]. Subsequently the Red Herring Prospectus of Quess was filed allowing a closer look at Quess to learn more about how the business is operated.

Previously Quess financials were reported as part of TCIL results. The figures for FY 16 extracted from TCIL audited results and assumed to be Quess are shown in Table 1[8]:

Table 1 Figures in ₹ millions

	Year ended March 2016	15 months ended March 2015	Year ended Dec 2013	March 16 over Dec 13, times
Human Resource Services				
Revenue	34,220	25,530	8,508	4.0
Profit before Interest and Tax	1,569	1,285	451	3.5
Capital employed	5,934	2,542	1,499	4.0

We see that while Revenue and PBIT grew by 4 and 3.5 times respectively, the capital needed to be employed also grew alongside at a faster pace than PBIT. Consequently it is important to find out if the underlying earnings growth were largely on account of internal equity or on account of external equity funding, and, other such economics of the business.

What follows are some observations based on the RHP filed by the company and other publicly available sources. The observations are divided into two parts – business performance, meaning observations relating to the economics of the business and, business conduct, meaning observations regarding how certain business arrangements are made. I do not own any shares in Quess or its competitors nor do I have any commercial interest in this report.

Observation on business performance

1. Operating Cash flow for the Quess group (called Quess henceforth) has been *negative* over the past 5 and half years until Sept. 2015, at ₹ - 68 million despite net profits of ₹ 1,392 million[9]. This is on account of ballooning working capital needs as revenues jumped from a monthly rate of ₹ 230 million in FY 11 to ₹ 2,559 million in the 6 months ending Sept. 30 2015[9]. Being a thin margin and operations intensive business where direct costs are more than 90% of revenues[10], cash generated was not sufficient to fund additional expenses needed for stupendous revenue growth. As an illustration, if you want to grow top line by 50%, you need 45% of it funded and your current earnings will give you no more than 10% so you need to fund the 35% from outside. You may accelerate your receivables and delay your payables to reduce external funding but that is not easy. On that count Quess working capital gap has been worsening. While its receivables (including accrued revenue) have declined from 4 months in FY 11 to 2.1 in HY 16, payables (including "Other current liabilities") have declined even faster from 4.2 months to 1.2 for the same periods. As a result working capital needs have gone up from a negative 0.2 months in FY 11 rising up to 0.9 months now[11].
2. The funding for growth comes from borrowing despite stated aversion to it. Borrowings have shot up from ₹ 363 million end of FY 11 to ₹ 2,617 million end of Sept 2015[12]; by about 7.2 times. This is inconsistent with what AI said in a talk given to students that *"….this fixation that we will not to borrow to grow helped us develop this DNA that we will make enough money we need to support our growth in the future"*[13,14].
3. The scale effects of the business are not seen in the biggest cost component of its economics, i.e. direct costs. Direct costs, which includes costs of services and employee expenses constituted 90.3% of revenues in FY 11 and increased to 90.9% in HY 16, despite scaling up revenues by more than 10 times[9].

4. The various business segments as classified by Quess show that its mainstay business of people staffing is getting less profitable, while newer segment carry higher margins. In the traditional and the largest segment "People and services", i.e. general staffing, Profits After Tax or PAT as % of sales has dropped from 5.3% in FY 11 to 3.3% in HY 16 and contributed 38% of PAT, down from 80% in FY 11. The "Global technology solutions" segment providing "IT staffing, IT product solution and services", saw a rise from 3.2% in FY 11 to 8.4% in FY 15 and dropping to 5.9% in H1 FY 16. Similarly "Integrated facility management" saw its margins rise from 2.1% to 11.4% before falling to 5%. Note that these segment PAT do not carry any unallocated expenses[15].
5. Part of the IPO proceeds will be used to fund capital expenditure of a subsidiary MFX US, which, along with various subsidiaries and related entities was acquired from the parent shareholder of TCIL, Fairfax Financial Holdings Ltd (FFHL). However Quess is required to pay 40% of net income from MFX group for a period of 5 years until Dec 2019 to the parent Fairfax Financial Holdings Ltd. In short IPO funds will be partly used to enhance earnings for FFHL, not Quess owners, even as Quess buys it from FFHL with no equity and only debt worth ₹ 314.1 million. The negative equity despite, "*MFX has a track record of around 15 years in developing IT solutions, particularly focused on the P&C insurance industry*"[16].

Observations on business conduct

The following section makes observations on certain business arrangements involving AI that maybe seen as conflicts of interests and maybe seen inconsistent with the stated rationale for renouncing Quess shares by TCIL in favor of AI.

1. While TCIL said that the shares will be towards securing AI's full commitment by helping him keep control with a 25% holding, the shares have *not* been renounced to him. The shares have been renounced to a firm owned by him and Ms Sarah Isaac called Net Resources Investments Pvt Ltd (NRIPL). TCIL had said it will "renounce them in favour of Mr. Ajit Isaac and/or his nominees." but no share has been renounced to Mr Ajit Isaac. Further AI himself renounced his rights in favour of NRIPL[2,17].
2. NRIPL has two directors, AI and Subrata Nag (SN). However SN is also the CFO, Executive and Wholetime Director of Quess Corp. In other words SN serves shareholders of Quess (and indirectly of TCIL) and also serves AI in a separate and potentially conflicting capacity. SN has been serving NRIPL possibly since 2006. Further NRIPL and Quess share the same registered address indicating that they possibly share some resources and attention of management / directors at the same time[18].
3. FY15 audited accounts of NRIPL shows that it is an active company, and has grown substantially after the TCIL acquisition of Quess. Its equity grew from ~₹ 6.5 lakhs end of FY 13 to 8 crores in FY 15 indicating it was capitalised after the Quess acquisition by TCIL, for various activities. The entire operating income of NRIPL of ₹ 2 crore in FY 15 is by way of providing "rental services" to Quess. It was nil income in FY 14 when it also purchased land worth ₹ 3.6 crores. About ₹ 7.6 crores of buildings were added and let out to Quess. The biggest operating expense was "Donations" at ₹ 32.5 lakhs. Absent this the PBT was 40% of revenue. Further the implied rental yield was atleast ~16% (total cost of fixed assets, all assumed to be for let out was ₹ 12.5 crores against a rent of ₹ 2 crores). Typical rental yields are in the range of 3% - 4% for a bare shell in Bangalore and thus this seems high[18].
4. A firm acquired by Quess in Dec 2015, Styracorp Management Services, had indirect equity in Quess potentially worth ~₹ 200 million via NRIPL that it gave up for ₹ 45 lakhs. Styracorp was a loss making entity with eroded net worth (FY 15 loss at 18 lakhs and negative networth) and acquired by Quess in Dec 2015 and said "*The acquisition marks the entry of Quess people and services business in the Middle East*"[19]. However prior to this acquisition, Styacorp had rights to Compulsorily Convertible Preference Shares of 5.52% of NRIPL which were bought back by NRIPL at ₹ 15 per share for ~₹ 45 lakhs. AI was the earlier owner of Styracorp and was paid ₹ 19 million to relinquish ownership of Styacorp, Subsequently Quess paid ₹ 20 million for Styacorp and IME Consultancy (figures are not separately provided).
5. NRIPL has availed loans by securitising its rent receivables from Quess; these loans have been used to create assets that will be used by Quess (as implied by the rental income earned) at yields that atleast in FY 15 appeared to be higher.
6. Finally, NRIPL, owned and run by AI, has amended it MOA a few months ago to get into various businesses including real estate, indicating that AI has increased his commitment to this entity. This means that despite renouncing shares at par "to secure his *[AI]* full commitment to the Quess performance" TCIL owners may not get AI's full commitment.

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1. http://articles.economictimes.indiatimes.com/2015-12-29/news/69379945_1_500-crore-250-crore-prem-watsa

2. Extracted from communication with Thomas Cook shareholders
3. http://www.bseindia.com/xml-data/corpfiling/AttachHis/4B55161D_750A_478D_AF49_371F4914403D_124759.pdf
4. SES Proxy Advisory Report
5. http://quesscorp.com/about/board-of-directors/
6. https://fundooprofessor.wordpress.com/2015/07/10/intelligent-fanatics/
7. https://en.wikipedia.org/wiki/Prem_Watsa
8. http://www.thomascook.in/tcportal/downloads/Standalone%20and%20Consolidated%20financial%20results_28.05.2016.pdf, http://www.thomascook.in/tcportal/downloads/Business-wise%20Audited%20Financial%20Results.pdf
9. Page 204 – 206 of RHP, sourced from SEBI website here - http://www.sebi.gov.in/cms/sebi_data/attachdocs/1454475043546.pdf
10. “Employee benefits expense” and “Cost of services” line items are taken as direct costs from the P&L statement in page 205.
11. Receivables include “Trade receivables” and “Accrued revenue” and Payables include “Trade payables” and “Other current liabilities”. As pee page 105, “Other current liabilities” *primarily include trade payables, accrued salaries and benefits, provision for expenses, income received in advance, advance received from customers, rent escalations, statutory liabilities and other liabilities.* Number of months has been computed as months of end of period receivables / payables as proportion of period revenue / non-depreciation expenses
12. Page 204 – 206 of RHP, sourced from SEBI website here - http://www.sebi.gov.in/cms/sebi_data/attachdocs/1454475043546.pdf and borrowings are the sum of “Long term borrowing”, “Short term borrowings” and “Current maturity of long term borrowings”.
13. https://www.youtube.com/watch?v=gJP-_Iwm-N8&list=PL5rAd0gCa7MBMiI5SO0xZy9VaAJujLTcY&index=21, from time 1:36
14. Page 100 of RHP, sourced from SEBI website here - http://www.sebi.gov.in/cms/sebi_data/attachdocs/1454475043546.pdf
15. Pages 237 to 242, sourced from SEBI website here - http://www.sebi.gov.in/cms/sebi_data/attachdocs/1454475043546.pdf
16. Page 26, 100 and 140 of RHP, sourced from SEBI website here - http://www.sebi.gov.in/cms/sebi_data/attachdocs/1454475043546.pdf
17. Page 254 of RHP, sourced from SEBI website here - http://www.sebi.gov.in/cms/sebi_data/attachdocs/1454475043546.pdf
18. Public documents of NRIPL sourced from MCA
19. http://www.thomascook.in/tcportal/downloads/Quess_Corp_Ltd_acquires_Styracorp-22122015.pdf