Rescuing CG Power: Lessons from Fortis' playbook

It is in the interest of all stakeholders to ensure CG Power and Industrial Solutions Limited (CG Power) remains operational. For the company to continue to run - taking a leaf out of Fortis Healthcare Limited's (Fortis) playbook - the immediate task is to ensure liquidity does not dry up. For this the company needs to present a true and fair picture to all stakeholders, particularly its lenders. And, to instil confidence regarding the seriousness of purpose, it needs to change its board and management. The buck stops with the board; it is also the starting point from which to rebuild the company.

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Sever the past and think about the future. That is the only way CG Power is likely to get out of its current bind. In the interest of all stakeholders, the company needs to be rescued. Selling the company for parts or going through the Insolvency and Bankruptcy Code (IBC) will return little to existing stakeholders – both on the debt and equity side – and will likely result in job losses that the current economy can ill afford.

At this stage, we assume that the company's operations are still viable. The disclosures put out by the company seem to suggest several concerns over the balance sheet (Exhibit 1). The limited disclosures with respect to operations were limited to inflated revenues (Rs.1.20 bn) and inventories (Rs.2.58 bn), and unauthorized expenses towards avoiding warranty claims on transformers (Rs. 2.16 bn for the period under restatement). These have already been rolled-back, following which FY19 revenues stood at Rs.53.6bn and EBITDA (before forex losses) was Rs. 6.37 bn.

CG Power's rescue will require multiple aspects to be managed simultaneously. The role of the board (Exhibit 2) will become critical, now that the financial shenanigans have been disclosed. The immediate focus areas for the company are:

1. **Keeping liquidity afloat**
   The restatement of liabilities effectively means that debt levels have almost doubled, assets against these loans are not return yielding, and the cash flow from operations is likely unchanged. The focus for the business, at this point, will be to ensure operations continue to generate cash and that the liquidity in the company does not dry up.

   The company will need to raise both equity and debt. In the current economic environment, bankers are already reticent in lending, and investors are shy of taking on risks. Asking them to lend to a company that has restated its financial statements and disclosed under-reporting of loans of over Rs. 10bn is going to be a tall task. There

needs to be a dedicated board member, with decision-making power, to regularly talk to both lenders (Exhibit 3) and institutional shareholders (Exhibit 4).

Fortis' experience was that directors had to go down to the details of monitoring monthly cash flows, project monthly cash flows and continuously engage with lenders to ask for a moratorium or negotiate new lines. In the absence of any support from investors and lenders, the company will likely to have find a buyer – like Fortis did in IHH – to infuse sufficient funds to keep the business running.

2. **Biting the bullet on financial restatements**

For there to be a precise discussion on funding requirements for the business, the size of the hole in financial statements needs to be defined. The current restatement of accounts is based on the findings of a task force (Operations Committee) created by the board. But it remains unclear if we have reached the nadir or there is more to come. A forensic audit needs to be conducted as soon as possible and the board needs to take as many write downs as required. This may require taking some difficult decisions and could result in the financial statements being more depressed than already disclosed – but this will at least establish the new starting point and stop any further surprises.

The other big agenda for the board is to establish internal controls. The degree of unauthorized transactions suggests almost absent internal controls, independent of the auditors' assertions in their FY18 audit report. The board needs to quickly identify and plug the gaps so that further leakages are stopped.

It seems unconscionable that auditors (Exhibit 5) were not able to catch some of the egregious transactions that have been reported by the board. Inflated cash balances (on 31-Mar-17 and 31-Mar-18), writing off loans against debtor positions (in 2017-18), and mutual fund investments (made by foreign subsidiaries) being netted off against loans (in 2017-18) should have been caught even by rookie auditors. In light of the number and size of unauthorized transactions, certifying that "*the Company has, in all material respects, an adequate internal financial controls system over financial reporting*" and that these controls "*were operating effectively as at March 31, 2018*" makes a mockery of the audit, even if one were to respect the "*inherent limitations of internal financial controls over financial control*". SRBC & Co LLP, which was appointed for five years in September 2018, may just be able quell some of the stakeholders' concerns with respect to audit quality.

3. **Balancing the need to keep some people and letting go of others**
For the company to be rescued, there needs to be continuity in operations and management. The board will need to spend time with the key people at the operating level to ensure they stay through what will be a significant upheaval within the company. The board will also need to let go of people – those that were party to some of these fraudulent transactions, and others that possibly turned a blind eye as these violations occurred. Fortis decided to keep the CEO on despite him having been appointed by its previous promoters and it was only after IHH took over that the CEO was replaced.

4. **Getting the regulators involved and yet keeping them at bay**
The regulators will have to step in – and it will likely be a myriad of them. SEBI, MCA, SFIO, and the ED will be just the first few to kick in almost immediately. In the past, regulators have been over-zealous, sometimes freezing assets of Independent Directors, audit firms, and audit partners, before establishing their culpability. The board needs to proactively manage the communications with the regulators in two aspects – to isolate the nature of the problem and the people involved and support them with all the information that these regulators need. This will ensure that when regulatory action takes place, it is consistent, coherently and keenly targeted.

5. **Severing from the past by refreshing the board**
The board (Exhibit 2), especially members of the Risk and Audit Committee (Exhibit 6), during the restatement period of FY17 to FY19 must be held accountable for the improper transactions that have taken place. The recent disclosure articulates the involvement of certain management personnel and non-executive directors in the financial shenanigans, and yet there have been no resignations. The Managing Director has been kept away from day-to-day management, and Sudhir Mathur, who joined the board as an Independent Director, has become a whole-time director. But that is not enough. To instil confidence and garner support from market participants, stakeholders need to know that the company is making a fresh start, with a new board and a new management are in control. Not only does the old guard have to cede control, but a new guard comprising well-respected individuals need to take control. Institutional investors have raised concerns over the reappointments of certain non-executive directors (Exhibit 7) in the past, but now there cannot be any ambiguity on how they view these decisions. Shareholders holding more than 10% of the capital (Exhibit 8) must move a resolution to remove directors and appoint Independent Directors or even nominee directors (just as Fortis' shareholders).

There has been wrongdoing - several, actually - and there must be punishment. But first shareholders need to play their part in ensuring that an effective solution is found for CG Power. There are several parallels that can be drawn from Fortis – and the most important one is to keep the company and its operations alive. Shareholders must swing into action to save the company from its current board and leadership.

Exhibit 1: Summary of the concerns raised in the company's disclosure

- Unauthorized sale / assignment of land and factor buildings (Nashik, Kanjurmarg)
- Unauthorized raising of debt, making the company a co-borrower, and pledging its assets. Debt was raised in foreign subsidiaries and the money was advanced to promoter affiliate companies.
- Disguising debt levels by:
  - Writing off loans against receivables
  - Netting off mutual fund investments (made by overseas subsidiaries) against debt
- Disguising interest and finance costs as professional fees, supplier advances, and exchange losses
- Transfer of funds to Avantha Holdings Limited and other entities in which CIPs were interested
- Unauthorized creation of power of attorneys, signing undertakings, and entering into MOUs with lenders
- Comfort letters and post-dated cheques issued by CG Power to support promoter debt
- Incorrect write-off of advances and receivables from related parties – these could be recoverable.
- Assignment of future royalty payable by CG Power to Avantha Holdings – despite the revised terms of royalty not being agreed upon. Against these assignments of future royalty, CG Power's fixed deposit was provided as a collateral.
- FD receipt dated 1 October 2018 while funds towards FDs were transferred only on 25 October 2018
- Cheques received from the promoter group were accounted in the cash balance – but these cheques were not deposited because the promoter entities' bank accounts had insufficient funds. Therefore, cash balances were inflated.
- Inflating sales and writing down the receivables so created through a purported factoring transaction. Inventory was inflated to show purchases against the inflated sales.
- Purchasing local services to ratify product quality issues in transformers (to avoid warranty claims) without authorization
- Not disclosing certain entities as related parties, with whom agreements were signed and money was transferred

The above list is a simplified summary of the issues raised – some of the transactions are more complicated. IiAS recommends a reading of the entire notes to accounts in the company's disclosure here: http://tiny.cc/gxksbz

Exhibit 2: CG Power's board composition over the past four years

Name	Designation	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19	31-Jul-19	Board tenure (approx.)
Gautam Thapar	Non-Executive; Chairperson	✓	✓	✓	✓	✓	19½ years
K N Neelkanth	CEO and Managing Director	from 3-Feb-16	✓	✓	✓	✓	3½ years
Sudhir Mathur	Independent Director / Whole-Time Director	-	-	-	ID from 1-Oct-2018	WTD from 10-May-19	10 months
Omkar Goswami	Non-Executive Director	✓	✓	✓	✓	✓	15½ years
Jitendra Balakrishnan	Independent Director	-	-	from 2-May-17	✓	✓	2¼ years
Ramni Nirula	Independent Director	-	from 6-Apr-16	✓	✓	✓	3¼ years
Ashish Guha	Independent Director	-	-	from 9-Nov-17	✓	✓	2¾ years
Narayan Sheshadri	Independent Director	-	-	-	from 8-Mar-19	✓	6 months
Valentin Von Massow	Independent Director	✓	✓	✓	✓	✓	about 10½ years; tenure completed on 5-Aug-19
Sanjay Labroo	Independent Director	✓	✓	✓	Upto 1-Oct-18	-	16 years
B Hariharan	Non-Executive Director	✓	✓	✓	Upto 8-Mar-19	-	about 6½ years
Madhav Acharya	Executive Director (Finance)/Non-Executive Director	-	from 1-Apr-16	Upto 30-Sep-17	-	-	1½ years
Shirish Apte	Independent Director	✓	✓	Upto 1-Apr-17	-	-	4 years
Meher Pudumjee	Independent Director	✓	Upto 28-May-16	-	-	-	about 9½ years
Colette Lewiner	Independent Director	Upto 14-Mar-16	-	-	-	-	3¼ years
Laurent Demortier	CEO & MD / Whole-Time Director	✓	-	-	-	-	4¾ years

Source: Annual Reports, company filings, www.indianboards.com *ID = Independent Director; WTD = Whole-Time Director*

1. *Sanjay Labroo ceased to be a director on the board following changes in SEBI Regulations on board interlock. Gautam Thapar was an Independent Director on the board of Asahi India Glass Limited, in which Sanjay Labroo was Managing Director and CEO. Because of the change in regulations, Sanjay Labroo was reclassified as a non-executive director (from Independent Director) with effect from 1 October 2018, and he chose not to offer himself for reappointment because of preoccupation and time constraints.*
2. *B Hariharan, Group Director (Finance) of the Avantha Group, resigned from the board on 8 March 2019 on account of pre-occupation*
3. *Madhav Acharya was re-designated Non-Executive Director with effect from close of business hours on 11 August 2017. Thereafter, he ceased to be a Director from 30 September 2017.*
4. *Laurent Demortier was CEO and Managing Director till 3 February 2016 and continues as a Whole-Time Director till 31 March 2016*

Exhibit 3: CG Power's lenders on 31 March 2018

- State Bank of India
- Axis Bank
- Bank of Maharashtra
- Barclay's Bank
- Corporation Bank
- Canara Bank
- ICICI Bank
- IDBI Bank
- IndusInd Bank
- Standard Chartered Bank
- Yes Bank

Source: CG Power's 2018 Annual Report

Exhibit 4: CG Power's shareholders on 30 June 2019

Sr. No.	Name of the shareholder	No of shares held	% holding
1	Avantha group (promoters)	8,574	0.0
2	Vistra ITCL India Limited	13,53,92,496	21.6
3	Yes Bank Limited	8,00,50,285	12.8
4	HDFC Equity Fund	5,74,51,000	9.2
5	Aditya Birla Sun Life Frontline Equity Fund	5,59,60,974	8.9
6	Bharti (SBM) Holdings Private Limited	5,19,69,354	8.3
7	Franklin India Equity Fund	2,00,00,000	3.2
8	Life Insurance Corporation Of India	1,41,05,321	2.3
9	Reliance Multi Cap Fund	1,27,36,644	2.0
10	IDFC Sterling Value Fund	96,00,000	1.5
11	Vanguard Total International Stock Index Fund (FPI)	67,83,725	1.1
12	Dimensional Emerging Markets Value Fund (FPI)	67,82,084	1.1
13	Institutional Investor Advisory Services India Limited (IiAS)	1	0.0
14	Other shareholders (retail / bodies corporate)	12,42,11,061	19.8
15	Other FPIs	4,47,09,013	7.1
16	Other institutional investors	62,98,376	1.0
	Total	**62,60,58,908**	**100.0**

Source: Stock exchange filings, IiAS Research

Exhibit 5: CG Power's auditors

	FY16	FY17	FY18	FY19++
Audit firm	Sharp & Tannan	Sharp & Tannan	K. K. Mankeshwar & Co.	K. K. Mankeshwar & Co.
Firm registration No.	109982W	109982W	106009W	106009W
Audit Partner	Milind P Phadke	Vinayak M Padwal	Ashwin Mankeshwar	
Membership Number	033013	049639	046219	

Audit firm	Chaturvedi & Shah	SRBC & Co LLP
Firm registration No.	101720W	324982E/E300003
Audit Partner	Parag D Mehta	
Membership Number	113904	

Source: Annual Reports, BSE filings, IiAS Research

++ FY19 audited financial statements are yet to be published by the company

1. *Sharp & Tannan were the company's auditors for 20 years. Following changes in regulation, the audit firm needed to be rotated.*
2. *Chaturvedi & Shah were appointed in the 2016 AGM for a period of five years. They conducted a joint audit with Sharp & Tannan for FY17. The firm resigned in 27 April 2018.*
3. *K K Mankeshwar & Co were appointed to fill the casual vacancy caused by the resignation of Chaturvedi & Shah, and appointed in the 2018 AGM as joint statutory auditors for five years.*
4. *SRBC & Co LLP were appointed as joint statutory auditors in the 2018 AGM for five years. CG International BV, one of CG Power's subsidiaries, was to raise USD 250 mn from a consortium of international lenders – this debt would be used to refinance both domestic and foreign currency debt. The pre-requisite of this disbursement was that the company appoint one of the 'Big Four' audit firms to audit its financial statements from September 2018.*

Exhibit 6: CG Power's Risk and Audit Committee

	31-Mar-16	31-Mar-17	31-Mar-18	31-Mar-19	30-Jun-19
Jitendra Balakrishnan	-	-	Chairperson	Chairperson	Chairperson
Shirish Apte	Chairperson	Chairperson	-	-	-
Sanjay Labroo	Member	Member	Member	-	-
Omkar Goswami	Member	Member	Member	Member	Member
Ramni Nirula	-	Member	Member	Member	Member
Sudhir Mathur	-	-	-	Member	upto 11-Jun-19

Source: Annual Reports, Corporate Governance filings on BSE

Exhibit 7: Institutional investors have expressed reservations on the reappointment of two of CG Power's non-executive directors in the company's 2017 AGM (held on 22-Sep-2017)

Resolution: Reappoint Omkar Goswami as Non-Executive Director

	No. of shares held A	No. of shares voted B	% of shares voted C = B/A	FOR votes D	AGAINST votes E	% FOR F = D/C	% AGAINST G = E/C
Promoters	215.45	215.45	100.0%	215.45	0.00	100.0%	-
Institutional Investors	329.00	226.09	68.7%	171.27	54.82	75.8%	**24.2%**
Other shareholders	82.29	5.14	6.2%	5.14	0.00	100.0%	0.0%
Total	**626.75**	**446.69**	**71.3%**	**391.86**	**54.83**	**87.7%**	**12.3%**
Outcome	**Passed**						

Note: No. of shares / votes in millions
Source: BSE Filings, www.iiasadrian.com

Resolution: Reappoint Gautam Thapar as Non-Executive Director

	No. of shares held A	No. of shares voted B	% of shares voted C = B/A	FOR votes D	AGAINST votes E	% FOR F = D/C	% AGAINST G = E/C
Promoters	215.45	215.45	100.0%	215.45	0.00	100.0%	-
Institutional Investors	329.00	226.09	68.7%	170.42	55.68	75.4%	**24.6%**
Other shareholders	82.29	5.14	6.2%	5.14	0.00	100.0%	0.0%
Total	**626.75**	**446.69**	**71.3%**	**391.01**	**55.68**	**87.5%**	**12.5%**
Outcome	**Passed**						

Note: No. of shares / votes in millions
Source: BSE Filings, www.iiasadrian.com

Exhibit 8: Procedure for calling an EGM (Section 100 (2) of Companies Act 2013)

- The Board shall call an EGM on the requisition made by shareholders -
  - In the case of a company having a share capital - holding not less than 10% of the paid-up capital of the company on the date of receipt of the requisition.
  - in the case of a company not having a share capital - holding 10% of the total voting power of the company on the date of receipt of the requisition
- The members should provide the requisition to call an EGM in writing or through electronic mode at least 21 days prior to the proposed date of the EGM.
- The notice should specify the place, date, day and hour of the meeting and contain the business to be transacted at the meeting. It is not mandatory to provide an explanatory statement for the proposed resolutions. Further, the requisitionists may disclose the reasons for proposing the resolutions. The meeting should be convened at the registered office or in the same city or town where registered office is situated on working day.
- The notice shall be signed by all the requisitionists or by a requisitionist duly authorised in writing by all other requisitionists and delivered at the registered office of the company.
- If the Board does not, within 21 days from the date of receipt of such requisition, proceed to call an EGM on a day not later than 45 days from the date of receipt of such requisition, the EGM can be called and held by the requisitionists themselves within a period of 3 months from the date of the requisition and reimburse any reasonable expenses from the directors in default for holding the meeting.
- The EGM shall be called and held in the same manner as any other meeting held by the Board.

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