# Do Transactions with Related Parties influence Firm Value and Firm Continuity: Four Case Studies of Large Listed Entities in India

*The last two decades have seen several large corporate entities internationally as well as in India, failing unsuspecting non-promoter stakeholders, taking them completely by surprise. On investigations, it was most often found that corporate governance had failed. In most cases, especially in India, expropriations were alleged through a network of related parties, going undetected because of poor corporate governance practices. This article studies whether transactions with related parties could impact firm values and firm continuity. The four cases of leading corporates studied here do reveal an inverse relationship between volume of related party transactions and firm value and firm continuity. Read on...*


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## Introduction

This is a study on the effects of the volume of transactions with related parties on firm value and firm continuity and it arises from the need to understand various corporate insolvencies and reasons thereof. We examined the multitude of corporate failures from 2001 till last year and we found a great deal of commonality, in all these cases in terms of probable reasons of failure and poor corporate governance practices was the evident reason. The element of surprise to shareholders and investors was more pronounced than ever.

While in the West, Companies that failed, did so mainly due to reasons of window dressing of financials, unapproved loans, unapproved insider trading and sale of toxic assets to banks at sub-prime rates, the Indian Companies here, as investigations revealed, succumbed more to expropriation, through instruments such as tunnelling and siphoning off of funds through a maze of related parties by mechanisms like round tripping and teeming and lading, ever greening of inter-corporate dues and ultimate mergers, write offs of aged inter-company balances, fake capital and revenue expenditures, wrong classification of expenditure, obtaining loans against fake Letter of Undertakings (LUs) without underlying assets and loans against overleveraging and consequent diversion of funds to non-core losing businesses.

Very rightly therefore, unlike in the UK Code for Corporate Governance, the Indian Code for Corporate Governance for listed entities, laid down in the Listing Obligations and Disclosures Requirements Regulations, 2015, the Companies

Act 2013 itself, as also in the Indian Accountings Standards 2015, a great deal of focus on reporting, disclosure, regulations and audit of transactions with related parties.

Related Parties are entities which are able to influence business decisions of a company by nature of their structural relationship with that company e.g., relatives and associates, key managerial personnel, holding or subsidiary companies, persons with significant beneficial ownership and the like.

## Objectives

The objectives of this study were:

1. To examine whether high volumes of transactions with related parties should be dealt with in greater scrutiny as they could potentially be used as vehicles for actions detrimental to best-practices of corporate governance and therefore could go against Firm Value and Firm Continuity causing severe losses to non-promoter stakeholders. Firm Value here, is measured by Market Capitalisation-to-Book Value in relative terms (P:B), Book Value of Equity in Absolute terms and Firm Continuity is measured by Altman's Zed Score (Altman, EI: 2018).
2. To examine whether there could be a difference, arising from the style and structure of the organisation e.g., promoter-driven vis-a-vis professional-driven companies.

## Methodology

We selected two large-cap companies from the Bombay Stock Exchange BSE100. One, a promoter family-driven company and the other a professional-controlled company, and two large companies showing defaults. They have assets worth more than Rs 20 billion and turnover of more than Rs 50 billion a year, having significant network of related parties. We studied their related party transactions that is commercial, financial and intangibles related. The data we used are all from their annual reports, their filings, and their published rating rationales, available in the public domain. However, for the sake of ethical privacy we do not name these companies.

Market Capitalisation (M-Cap) is derived from the average of each month's closing market price, the Book Value (BV) is the total of free reserves and the paid-up value of tradable equity shares. We have also referred to Enterprise Values (EV) and their movements during the periods of study.

The drivers in Altman's Zed score (Zeta) are the same as in Edward Altman's definition – the weighted combination of five parameters of financial discipline and operational efficiency. The measurements are:

$$Zeta = 1.2\times X1 + 1.4\times X2 + 3.3\times X3 + 0.6\times X4 + 0.999\times X5.$$

where, X1 = Working Capital / Total Assets

X2 = Retained Earnings / Total Assets

X3 = Earnings Before Interest and Taxes / Total Assets

X4 = Market Value of Equity / Total Liabilities

X5 = Net Sales / Total Assets

The Interpretation of the Z-Score Model by Altman was:

Z score > 2.99 means "Safe" Zones

>1.81 Z score < 2.99 means "Grey" Zones

Z score < 1.81 means "Distress" Zones.

We categorize the Companies in three categories-

**Category A:** Companies where family promoters are in significant control of business decisions and these companies are in defaults.

**Category B:** Companies where family promoters are in significant control of business decisions and these companies have no default history.

**Category C:** Companies without promoter-families, run completely by professionals.

### Company - A1

Company A1, in Category A, used to be one of the large new-age players in the modern basic manufacturing industry. Its turnover was around Rs 13,000 crores and it had a CAGR of around 10.3% (against an industry average in that period of 5.2% (IBEF). The market for the automobiles sector (to whom this company used to primarily cater) was positive. Yet in 2017-18 when its assets were valued, an impairment of Rs 22,380 crore had taken place as per the Annual Report for 2017-18. Banks however, went on advancing fresh credits of Rs 18,000 crores even on the face of defaults of around Rs 6,000 crores. Creditors filed for recovery of dues through the National Company Law Tribunal (NCLT) in 2016. In 2017, it was taken over by another group through the NCLT Ruling under the Insolvency and Bankruptcy Code 2016.

**Table 1.1**

| | Company | Year | Related Party Transactions as % of Consolidated Turnover | Defaults | Enterprise Value (EV) .. Rs Crores | M-Cap Rs Crores | BV | M-Cap/ BV Ratio | Altman's z Score ..... ZETA= |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | Stand Alone | | | | |
| 1 | Company A1 | **2014-15** | 6.5% | 3.2% | 45,828 | 5,125 | 7,378 | **0.69** | **0.50** |
| | | **2015-16** | 7.5% | 5.0% | 48,234 | 1,133 | 4,171 | **0.27** | **0.39** |
| | | **2016-17** | 6.6% | 11.3% | 57,791 | 1,000 | -1,616 | **-0.62** | **0.34** |
| | **# Taken Over through NCLT defaults cleared by buyer** | **2017-18#** | 3.5% | # | 64,957 | 1,466 | -26,432 | **-0.06** | **-0.15** |

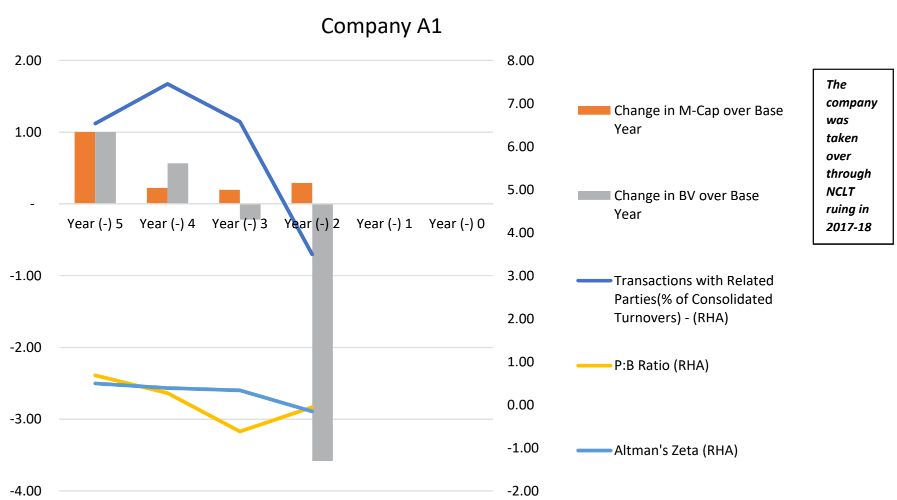
**Observations**

1. We see a steady rise in volumes of transactions with subsidiary or associate companies "related parties". 6.5% to 7.5% of consolidated turnovers. The reductions in the last year do not evidence planned control on volume of transactions with related parties – they are apparently parts of clean-ups post take-over.

2. Transactions with related parties: In just 2 years from 2014-15 purchases from related parties jumped 65% and advances given to related parties were Rs. 240 crores in one year where total cash generation from operations itself is Rs. 752 Crores as per the Cash Flow Statement.

3. We see defaults rise from 3% of gross debts in 2014-15 to 11.3% in 2016-17.

**Figure A.1 (Bars refer to the Left-Hand Axis and the Lines Refer to the Right-Hand Axis (RHA). (Figures are in percentages. P:B and Altman's score are indices)**




4. The EV increases mainly because of the increase in debts, where the M-Cap comes down 70%. The Rs 7,300 crores Book Value turns (-) Rs 26,000 crores.

5. The related party transactions apparently yielded no positive results to the subsidiaries either as seen in the consolidated financials from Table 1.2.

**Table 1.2**

| | Company | Year | EV.. Rs Crores | BV | M-Cap/BV Ratio | Altman's z Score..... ZETA= |
|---|---|---|---|---|---|---|
| | | | **Consolidated** | | | |
| 1 | Company A1 | **2014-15** | 45,926 | 7,049 | **0.73** | **0.52** |
| | | **2015-16** | 48,544 | 3,847 | **0.29** | **0.54** |
| | | **2016-17** | 57,604 | -1,573 | **-0.64** | **0.44** |
| | **# Taken Over through NCLT defaults cleared by buyer** | **2017-18#** | 64,952 | -26,079 | **-0.06** | **-1.96** |

**Company – B.1**

This Company (Category B) is India's largest integrated manufacturing company in the segment they operate. It had a stand-alone turnover of around Rs 43,000 crores in the last audited year. But like Company A1, Company B1 also has over one hundred related parties, subsidiaries, joint ventures and associates. Over the years, the transactions with these companies are also on the increase.

**Table – 2.1**

| | Company | Year | Related Party Transactions as % of Consolidated Turnover | Defaults | EV..Rs Crores | M-Cap Rs Crores | BV | M-Cap/ BV Ratio | Altman's z Score..... ZETA= |
|---|---|---|---|---|---|---|---|---|---|
| 2 | Company B1 | **2015-16** | 8.0% | 0.0% | 1,84,097 | 1,62,710 | 14,402 | **11.30** | **3.19** |
| | | **2016-17** | 10.7% | 0.0% | 1,47,259 | 1,31,651 | 22,767 | **5.78** | **3.54** |
| | | **2017-18** | 9.3% | 0.0% | 1,65,757 | 1,46,962 | 21,027 | **6.99** | **3.02** |
| | | **2018-19** | 9.6% | 0.0% | 1,53,989 | 1,36,547 | 19,769 | **6.91** | **3.06** |
| | | **2018-19** | 10.6% | 0.0% | 90,861 | 73,104 | 21,761 | **3.36** | **2.41** |
| | | **2019-20** | 9.2% | 0.0% | 74,316 | 51,503 | 17,946 | **2.87** | **0.84** |

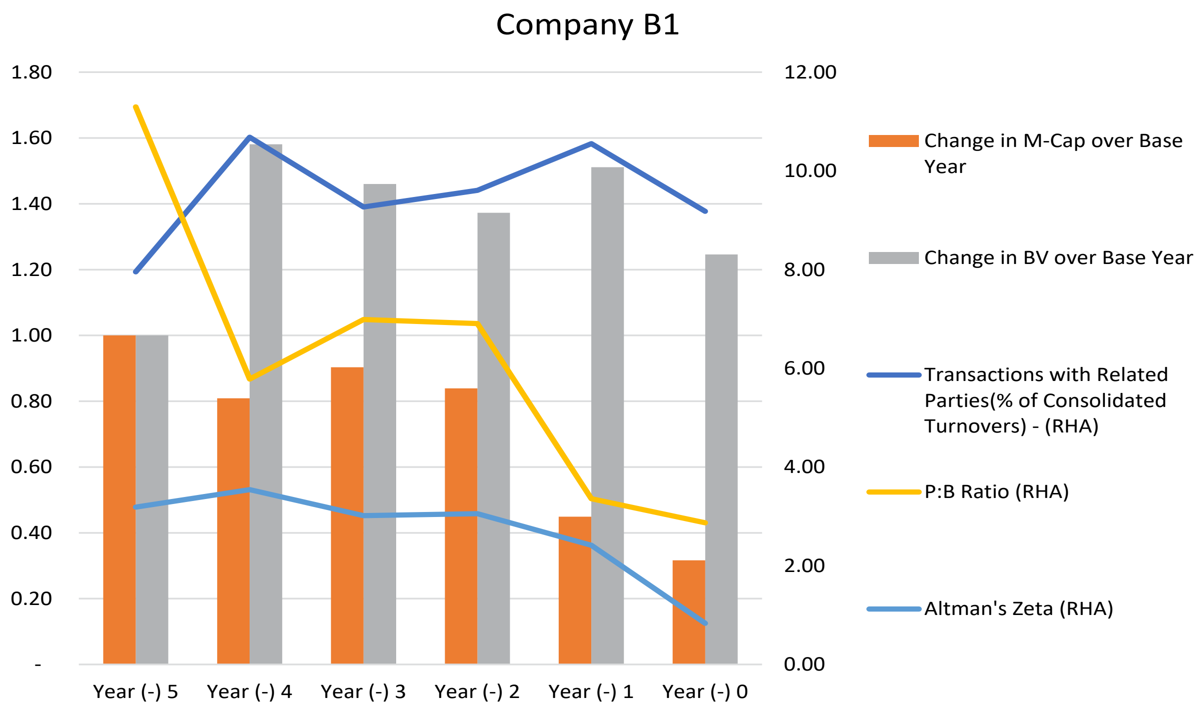
**Observations**

1. We see a consistently high volume of transactions with related parties sometimes more than 10% of consolidated turnover. The EV is seen coming down primarily because of diminishing profitability. It is quite an irony as the auto market in India was under booming conditions from 2014 till 2018.

2. The Book Value, the M-Cap and the EV are all seeing consistent falls as also the P:B.

3. The Altman's Zeta predicts insolvency from the last years' index, and this is in fact before the COVID-19 disruptions.

**Figure B.1**




4. To elucidate further, the volume of transactions with related parties significantly going up in fact seems to have quite a contrary effect on both these two measurements on the consolidated numbers i.e., firm value and firm continuity. There is a steady decline in the P:B Ratio and the Altman's Z Score goes much below the thresholds of 1.8. Refer to Table 2.2.

**Table 2.2**

| | Company | Year | EV..Rs Crores | BV | M-Cap/BV Ratio | Altman's z Score..... ZETA= |
|---|---|---|---|---|---|---|
| | | | Consolidated | | | |
| 2 | Company B1 | **2015-16** | 2,32,632 | 54,251 | **3.00** | **1.85** |
| | | **2016-17** | 1,99,078 | 78,699 | **1.67** | **1.58** |
| | | **2017-18** | 2,42,057 | 56,767 | **2.59** | **1.71** |
| | | **2018-19** | 2,19,775 | 94,262 | **1.45** | **1.47** |
| | | **2018-19** | 2,07,826 | 62,163 | **1.18** | **0.95** |
| | | **2019-20** | 2,18,260 | 59,060 | **0.87** | **1.04** |

**Company – C1**

This company(Category C), is one of Asia's largest vertically integrated E&C conglomerates, with a strong market position across segments such as infrastructure, heavy engineering, construction, defence, material handling machinery and industrial products. Its last audited annual turnover was around Rs 82,000 crores on an asset base of Rs 1,41,000 crores.

C1 also has an impressive net of over 140 Related Parties. Our findings are-

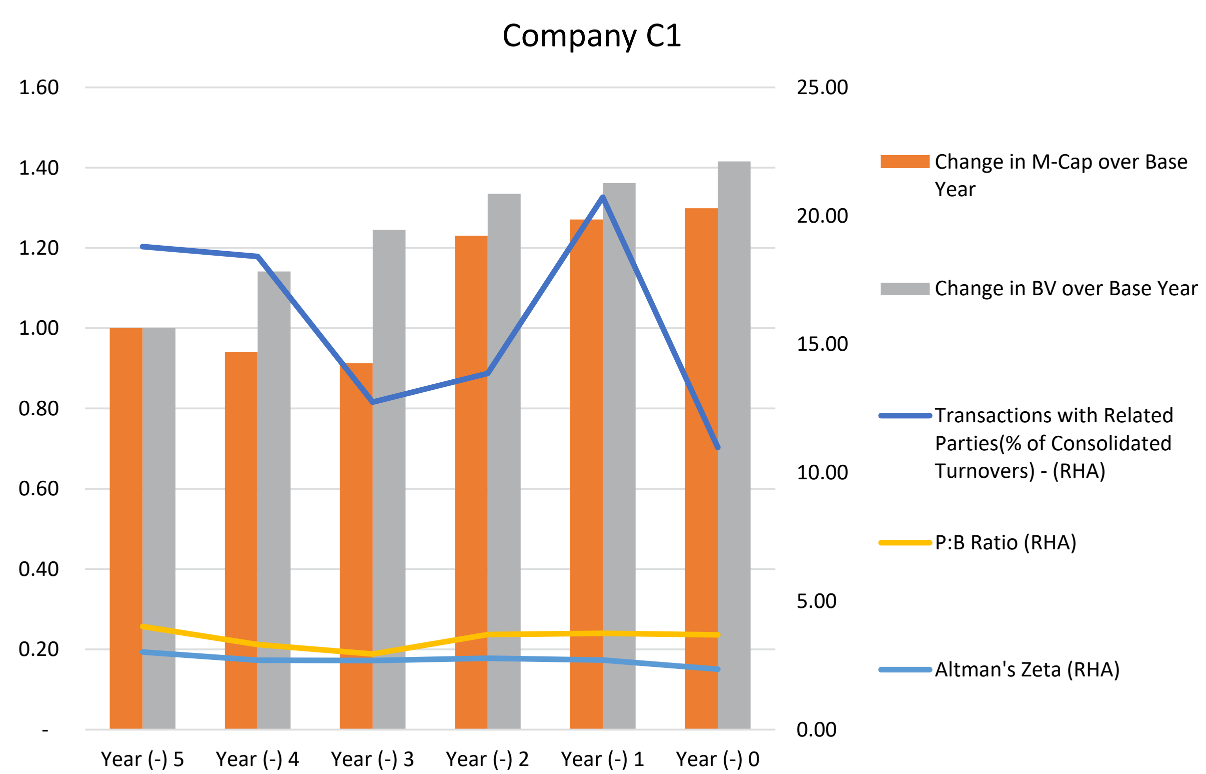
**Table 3.1**

| | Company | Year | Related Party Transactions as % of Consolidated Turnover | Defaults | EV..Rs Crores | M-Cap Rs Crores | BV | M-Cap/ BV Ratio | Altman's z Score..... ZETA= |
|---|---|---|---|---|---|---|---|---|---|
| | | | | **Stand Alone** | | | | | |
| 3 | Company C1 | **2015-16** | 18.8% | 0.0% | 1,57,694 | 1,46,191 | 36,404 | **4.02** | **3.01** |
| | | **2016-17** | 18.4% | 0.0% | 1,49,510 | 1,37,462 | 41,559 | **3.31** | **2.70** |
| | | **2017-18** | 12.7% | 0.0% | 1,42,040 | 1,33,420 | 45,313 | **2.94** | **2.69** |
| | | **2018-19** | 13.9% | 0.0% | 1,87,235 | 1,79,862 | 48,600 | **3.70** | **2.78** |
| | | **2018-19** | 20.7% | 0.0% | 1,95,087 | 1,85,821 | 49,561 | **3.75** | **2.71** |
| | | **2019-20** | 11.0% | 0.0% | 2,12,501 | 1,89,903 | 51,528 | **3.69** | **2.35** |

**Observations**

The subsidiaries most of which operate in the group's core area of operations viz., construction, infrastructure, and engineering have requirements of high working capital intensity but seem to offer lower returns in their initial years. It is more about volumes and size and price competitiveness. With the decrease in transactions with related parties – the market capitalisation improves by nearly 30% in 6 years, but the P:B ratio and the Altman's Zeta are on a downward movement primarily because of profitability constraints.

**Figure C.1**



1. This company has strategic investments through transactions with related parties where gestation is significantly higher, but outlooks are rated high.

**Table 3.2**

| | Company | Year | Related Party Transactions as % of Consolidated Turnover | EV..Rs Crores | BV | M-Cap/BV Ratio | Altman's z Score..... ZETA= |
|---|---|---|---|---|---|---|---|
| | | | | **Consolidated** | | | |
| 3 | C1 | **2014-15** | 18.8% | 2,63,187 | 37,449 | **3.90** | **1.49** |
| | | **2015-16** | 18.4% | 2,78,184 | 40,012 | **3.44** | **1.32** |
| | | **2016-17** | 12.7% | 2,28,900 | 50,299 | **2.65** | **1.60** |
| | | **2017-18** | 13.9% | 2,85,752 | 57,185 | **3.15** | **1.64** |
| | | **2018-19** | 20.7% | 3,05,219 | 65,804 | **2.82** | **1.64** |
| | | **2019-20** | 11.0% | 3,21,227 | 63,723 | **2.98** | **1.55** |

### Company – A.2

Company A2, (Category A), used to be a blue-chip domestic carrier, market leaders at one point of time flying around 400 flights a day to 70 destinations – a total revenue of Rs 23,000 crores on an asset base of Rs 12,000 crores. The company started defaulting and currently it has 82% of its debts in default. In 2018, its creditors referred the company to the insolvency and bankruptcy regulatory body and in October 2020, a resolution is said to be arrived at.

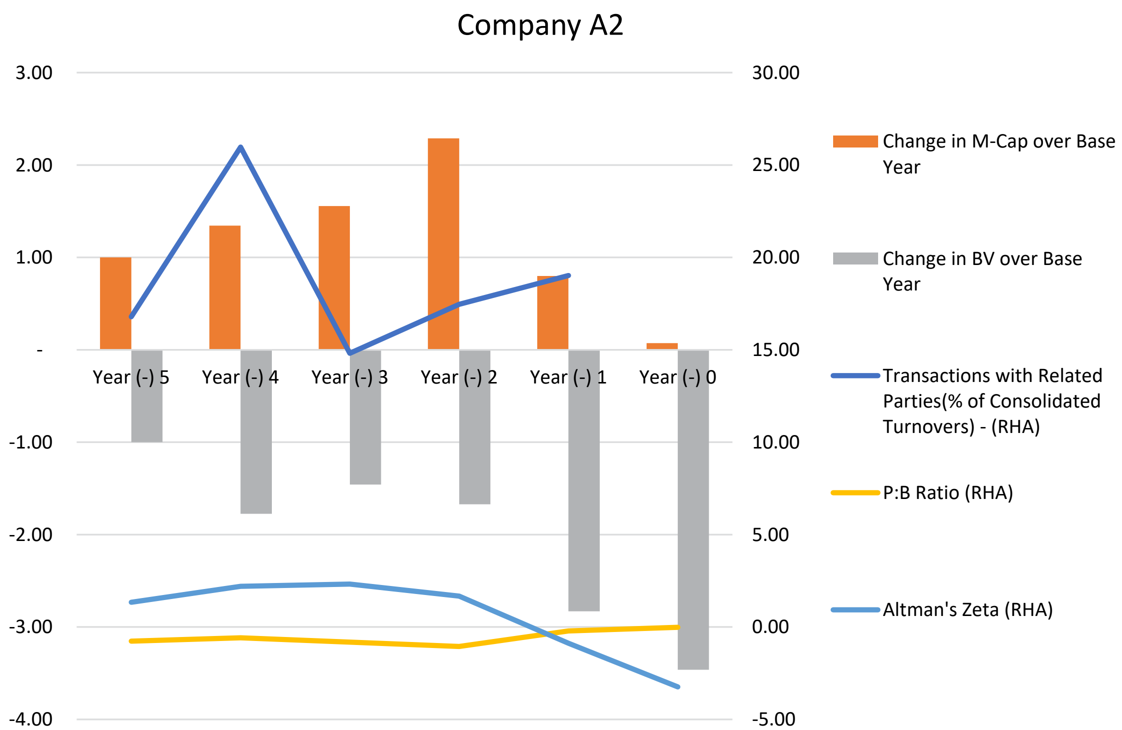
**Table 4.1**

| | Company | Year | Related Party Transactions as % of Consolidated Turnover | Defaults | EV..Rs Crores | M-Cap Rs Crores | BV | M-Cap/ BV Ratio | Altman's z Score..... ZETA= |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | **Stand Alone** | | | | |
| 4 | Company A2 | **2014-15** | 16.8% | 0.9% | 14,434 | 3,469 | -4,514 | **-0.77** | 1.34 |
| | | **2015-16** | 26.0% | 0.0% | 15,184 | 4,664 | -8,015 | **-0.58** | 2.20 |
| | | **2016-17** | 14.8% | 0.0% | 13,871 | 5,398 | -6,584 | **-0.82** | 2.33 |
| | | **2017-18** | 17.5% | 0.0% | 16,112 | 7,938 | -7,550 | **-1.05** | **1.67** |
| | | **2018-19** | 19.0% | 16.6% | 10,482 | 2,774 | -12,773 | **-0.22** | **-0.88** |
| | **##Operations suspended** | **2019-20** | 136.1% | 82.6% | 9,164 | 249 | -15,636 | **-0.02** | **-3.24** |

### Observations

1. The company has a consistently high volume of transactions with related parties. With the median values at 17.5% it is significantly higher than the recommended 10% cap in the corporate governance codes. From 14.8% 2016-17, it increased to 19% in just 2 years.
2. The P:B ratio records a constant fall, excepting for the outlier year 2017-18, when the joint operations with an international airline had completely stabilised.
3. The company's procedures at the NCLT are nearly complete and it is in the process of acquisition by another consortium.

**Figure A.2**




4. The financial management reflects in the P:B Ratio with a steady decline inversely proportional to the volumes of transactions with related parties but there is no trend visible in the Altman's Zed Score mainly on account of consolidation of its Subsidiary in Low Cost Carrier business' Turnovers and Results.

**Table 4.2**

| | **Company** | **Year** | **Related Party Transactions as % of Consolidated Turnover** | **EV..Rs Crores** | **BV** | **M-Cap/ BV Ratio** | **Altman's z Score..... ZETA=** |
|---|---|---|---|---|---|---|---|
| | | | | **Consolidated** | | | |
| 4 | Company A2 | **2014-15** | 16.8% | 15,070 | -6,379 | **-0.54** | 1.24 |
| | | **2015-16** | 26.0% | 14,514 | -8,055 | **-0.58** | 2.12 |
| | | **2016-17** | 14.8% | 15,084 | -6,613 | **-0.82** | 2.77 |
| | | **2017-18** | 17.5% | 16,131 | -7,212 | **-1.10** | **2.34** |
| | | **2018-19** | 19.0% | | **Consolidated Financials not published** | | |
| | **##Operations suspended** | **2019-20** | 136.1% | | **Consolidated Financials not published** | | |

## What was common to these cases?

In all four cases, when we correlate them to the objectives of our study we find-

1. In all cases in these companies, volumes of related party transactions are up in general over the retrospective period of six last years – they increase faster than increase in activities in Company excepting for Company C1.
2. We do not see corresponding increase in consolidated activities as well – so we cannot say that the transactions with related parties helped in growing the activities of the group overall.
3. There is steady rise in defaults in two of the three family-controlled companies A1 and A2. The one family-controlled company which still has no default (B1), has despite a negative cash flow from operations of Rs 1,455 crores, a negative cash flow from investing activities of Rs 4,718 crores, which therefore means the debts (Rs 25,000 crores) are not sustainable at these levels of activities.

   So, in the context of our study,

4. Measurements of firm value in Absolute Terms:
   a. Book Value (BV): again, in all three family-controlled companies the BV consistently comes down – when the volumes of related party transactions increase.
   b. Company C1 shows a healthy progress in both parameters.
5. Measurements of firm value in relative terms: P: B Ratio: In all four cases as stated in the objectives we find that the volume of related party transactions have had an adverse relationship with the P:B Ratio which as contended, is a conclusive measure of firm value.
6. Measurement of Firm Continuity: In all three cases of family-controlled companies, the Altman's Zed Score diminishes – even in the best of the three (B1), settles at less than 1.81 the threshold for prediction of possible bankruptcy, In case of the professionally managed company (C1) in its stand-alone position the Zed Score is down – but it improves in the consolidated activities, showing thereby – that fundamentally the group as a whole is operationally well under control and there are therefore possibilities of better firm values in future as well.

> Family-controlled companies have generally high levels of related party transactions, which when they increase disproportionately over a given period, can cause unsustainable financial health – in case of weaker ones, (with negative book values of equity) can result in even defaults and insolvency.

> It is ultimately firm value and firm continuity that a company works towards to sustain itself in the long run and it is important that it does so within proper and adequate corporate governance framework.

## Conclusions

1. It's therefore clear in these four cases that family-controlled companies have generally high levels of related party transactions, which when they increase disproportionately over a given period, can cause unsustainable financial health – in case of weaker ones, (with negative book values of equity) can result in even defaults and insolvency.
2. It is also true in a minority incidence of cases, (we saw just one in three), family or group companies can draw benefits from its group-entities or related parties in the short run, e.g., in terms of finances like we saw in Company B1 – the important thing is, it will come inevitably at costs, the business must increase its firm values and firm continuity to sustain in the long run – like again in the same company B1 the measurements in Altman's Zed Score clearly shows up.
3. The difference between the volume of transactions with related parties in C1, is the quality of the related party concerned, their synergic relations with one another and their core competence and central priorities within the structure. Whereas in case of Company B1, most of the transactions are with companies where the promoter aspires away from its core segments of business, in Company C1, the transactions are more with SPVs where the group have core interest and proven competence in growth but with larger gestation periods.
4. It is ultimately firm value and firm continuity that a company works towards to sustain itself in the long run and it is important that it does so within proper and adequate corporate governance framework, particularly one of its most important drivers – that of transactions with related parties. ■■■