

What ESG Tell Us About Adani.

February 6, 2023

Mike Disabato: What's up everyone? Welcome to the weekly edition of ESG Now where we cover how the environment, our society, and corporate governance affects and are affected by our economy. I'm your host Mike Disabato, and this week we discuss the high-stakes drama between the powerful Adani Group and a little known short seller called Hindenburg. This story is all about governance, folks. Thanks as always for joining us. Stay tuned.

The world of investing is not often one of high drama, but occasionally things get heated and very personal. Perhaps no more so than when a short seller who's an investor that has a vested interest in a company's stock price falling, when a short seller comes out with a hard-hitting report about why that company is being run badly, or is lying, or is on the brink of collapse, or sometimes all three. Such drama is happening this week between a small US-based short seller, called Hindenburg, and one of the world's richest men, or used-to-be richest men, Gautam Adani, and his sprawling empire that is an important piece of India's growing economy called the Adani Group.

Hindenburg released a report accusing Adani's leaders of quote, "Brazen stock manipulation and accounting fraud." Adani has said the allegations made are quote, "A malicious combination of selective misinformation and stale, baseless, and discredited allegations." While the report Hindenburg released is scathing, and Adani released its own massive 413 page response to it, we aren't going to go into those allegations. What we are going to get into today is why the governance structure of Adani Group was ripe for a short seller to successfully attack it. And it has been successful for Hindenburg in the sense that Adani stocks have already had a huge selloff of around a hundred billion US as of this report.

So first, let me tell you what the multinational conglomerate that is Adani Group is, because you need to know the structure of this empire if you are to understand why it could be accused of misleading investors and lying about its business. There are seven India-listed companies bearing the Adani name. They include firms in power transmission, green energy, port operation. Adani Group also owns cement producers, airport operators, coal miners, and a digital marketing company. It was founded in 1988 and has since grown into an important part of the entire Indian economy. Just think of all those companies I just listed.

So it's been around for 34 years. It's as old as I am. So why now? Why has the market sold off a hundred billion of Adani's company shares? Was it just the US-based relatively unknown short sellers report, or was it something more? What made the Adani Group vulnerable to this activist short seller? I put this question of why to my colleague, Zanele Mtshali, who covers governance for us and has been part of the team writing about the opaque governance structures at the Adani Group since 2017 when we first wrote our country report covering governance in India. She told me that the first thing to understand is, that we may be in 2023 in a period where a lot of companies, not just Adani, start to have to address difficult questions set by activist short sellers.

- Zanele Mtshali: We're basically coming out of a growth period, moving into a tighter period. So companies that seem more risky than peers, whether it's on governance, whether it's on ESG performance, and then also on financial performance. Companies that are outliers relative to their peers, whether it's in the industry, whether it's the market, are more likely to be targeted by short sellers as they potentially struggle to raise capital.
- Mike Disabato: We are expecting short sellers to be more active in markets in 2023. This might just be the beginning maybe for companies with governance structures below the global peer set. That's what Zanele is saying. So what do I mean when I say governance here? Well, for us we look at two aspects of governance. There's what we call corporate governance, and then there's corporate behavior. The discussion of why Adani was vulnerable encompasses both those things. But what Zanele is going to talk about a little bit more is the corporate governance aspects of this than anything else.
- Adani group must be pretty unique for it to be targeted by this short seller and for the market to respond the way it did. Well, it is and it isn't. With Adani, there is this risk created by overlapping spheres. It's the Adani family's outsized control. It's the way the Adani family uses their controlling shares in accompaniment with that outsized control, and how they operate their numerous company boards. But you must know this, corporate governance is a regional game. India is no exception.
- And in India, the structure of Adani isn't the exception, it's close to the rule. As Zanele is going to tell you, family ownership for example, isn't an issue when it comes to corporate governance. In India, she found that 66% of the companies in our regional index are family-owned firms. Where the risk creeps in is how much control the Adani family has over its listed companies. And by the way, you're going to hear Zanele's audio change a bit here in this clip as we had audio issues. But anyway, that's fine. Here she is.
- Zanele Mtshali: You know, family control in and of itself is not inherently bad. Where the risk to minority shareholders has come in is that you have the founder, Gautam Adani, who is the chair of all of the listed companies, and his family holds at least 60% of the holdings in all of these companies, right, so that means of the voting rights as well. So that means full minority. If you have any concerns about the structure of the governance, there is nobody independent you can go and speak to raise those concerns.
- So governance best practice recommends that companies address this by appointing one of the independent directors as the lead director to whom investors can address concerns about management, the board strategy, or anything else at the company. Adani has not done this because the founder is chairing all of the listed companies without appointing one of the directors as the lead independent director.
- Mike Disabato: Complications caused by not having a lead independent director are compounded when the company, for example, is a multinational conglomerate that spins off subsidiaries or acquires new companies to allow that conglomerate to grow and access new capital. That's exactly what a Adani is. To give you an understanding of how often Adani does this, by the way, it has seven companies which have over 500 legal subsidiaries as per their regulatory filings.
- Zanele Mtshali: In this particular case, like with a lot of sort of conglomerates, whether they're family or others, but in this case family conglomerates, these companies tend to grow through acquisitions, mergers, disposals. So what you want an independent board to do is to assess those sorts of transactions to make sure that they're in the best interests of everybody so that you're not buying a company that is maybe good for the family, or is related somehow to the family. So that means a family member or somebody like that makes a profit.
- Mike Disabato: What Zanele's talking about there are related-party transactions that are outside the norm. Because related-party transactions are carried out by most companies as part of

the normal course of business to reduce their costs for services and things like that. These transactions are common, especially across conglomerates where one part of the business can act as a supplier to a sister company. Think if you have a steel company that uses a lot of shipping. Why don't you just set up a shipping company that you can then give business to via your steel company?

The main risks with related-party transactions are if a company starts paying for goods or services, or starts providing them at non-competitive rates, at rates that are set because there's some sort of conflict of interest. The worst-case scenario for minority investors is that substantial money transfers can take place between the company and a sister company in a way that benefits certain insiders but destroys shareholder value. The Adani Group are incorporated in India, as I said, where related-party transactions require prior approval from the board-level audit committee. And the good thing is, is that Adani's audit committee is fully made up of independent directors.

So realistically, they should be able to give unbiased approval of these related-party transactions. But here's the thing. If the transactions are with family entities, and the family also sits on the board, and the directors on the committees are part of the family, there may not be a viable system for this independent audit committee to challenge this powerful group. Or they may challenge them, but the sort of systems that are needed to assuage and make markets confident might not be there. And so you can have the speculation of wrongdoing creep in when say an aggressive short seller releases a report accusing you of that.

Zanele Mtshali: In this sort of scenario where you've got the family also involved in the board of some of these companies, so particularly if we look at Adani's Enterprise's risk committee, which is responsible for oversight of the financial practices, of financial reporting practices, is fully independent, which is good and in line with how we would expect things to happen, and in line with best practice, and is basically set up to hopefully give as much protection to all investors as possible. But given the fact that the board itself is not completely independent of management, the influence of the family is something that is a risk for minority investors.

Now, it doesn't mean that those directors are acting badly, but as with anything, there is the potential for their influence to be felt by the rest of the board members. And that in itself could maybe make those directors not feel comfortable to challenge a transaction. It just raises the risk that people, because people are people, so people may not feel comfortable challenging the very powerful family even though they should have the ability to do so from the way the role is set up.

Mike Disabato: Another issue that we've seen in the past with Adani that Zanele mentioned were these things called pledged promoter shares. Now, Zanele is going to talk about this more, but just to warn you, you're going to hear a slight audio change again. Here she is.

Zanele Mtshali: This where the majority shareholder takes out loans against their stake or portion of their stake as collateral. This is common practice in India and other markets, so it's not unusual to see that in the Adani companies. But what the risk is to minority investors is that the loan shares can be sold on the open market if the debt obligations are not met. This could lead to dilution for investors and obviously share price volatility.

Mike Disabato: This sort of thing is actually pretty common practice for very wealthy founders to use their stock as collateral for personal loans in order to avoid things like income taxes. This has been widely reported by ProPublica in 2022. For example, through leaked IRS documents ProPublica showed that Elon Musk uses his Tesla stock as collateral for personal loans. But the reason this didn't cause an uproar for shareholders is because

Elon Musk only owns about 13% of Tesla. Whereas, the Adani family owns about 60% of their companies.

So Adani shareholders have a bit more reason to worry than Tesla's for example. And that's what we have to focus on here mostly is the concern around these accusations. Because another person could say, "Well, Adani is an extremely successful company that have woven itself into the Indian economy itself, and it's growing rapidly because of that. And Adani isn't even a particularly unique case in its structure when you look at other companies in India." As I noted, a majority of companies in the India Index that we cover have a family as a controlling shareholder.

A lot of companies in India have what's called concentrated ownership, where more than 30% of its voting shares are owned by a single shareholder group. So aside from these structures making things opaque and scary, if the company's doing well, and it's not actually based on fraud, why should shareholders care about these structures, these risky or maybe opaque governance structures? Well, as Zanele said, that the issue isn't when a market's on a bull run as it has been for the past decade it seems. It's when things turn, and as the tide recedes, the market tide, it reveals what's ever been thrown away and sunk, broken bottles, old gloves, rusting Poth cans, nibbled fish bones.

I'm quoting Margaret Atwood here from her 1988 book called Cat's Eye. But Warren Buffett said something similar in 1994 at his annual general meeting. He said that you don't find out who has been swimming naked until the tide goes out. The market is a confidence game, and investors seem worried that Adani has been caught swimming naked. Perceptions of risk sometimes are more important than whether or not those risks are actually there. And sometimes people just decide to cut their losses else they have to walk into shore naked and confused.

That's it for the week. I want to thank Zanele for talking to me about the news with an ESG twist. I want to thank you so much for listening. If you like what you heard, don't forget to rate and review us and subscribe wherever you get your podcast. You can hear myself or Bentley each week. It'll be great. Thanks again, and talk to you next week.

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