HOW TO SPOT A COMPANY GOING BUST

Watching out for telltale signs that might indicate impending doom for a company is not only healthy for your pocket, it can also be fun.

AFTER five years of investment analysis covering the worst recession since the Second World War, one becomes adept at spotting candidates for the corporate equivalent of Death Row. Often the end comes as an abrupt shock; however, if you read this article you are more likely to spot the next Polly Peck or Mountleigh before anyone else. Warning signs come well before the final countdown to receivership or, as the Americans would say, before the company becomes "financially challenged". Spotting the tell-tale signs can save you a great deal of money.

Myths

Firstly, beware myths peddled by companies or advisers about certain stocks or industries, however plausible they sound. In the late eighties one of the most common platitudes was "companies increase their spending on advertising to maintain their market share in the recession". WPP and Saatchi & Saatchi show how illusory this statement was.

Another common myth, whose greatest exponent was Coloroll, was that "high interest rates will only slow the rate of growth of consumer expenditure, not extinguish it"! Myths will be just as common coming out of the recession as going into it; for example no self respecting chief executive has neglected to include the following myth in their current results statement: "your company is perfectly poised to take full advantage of the recovery". In a similar vein investors should bolt the door when they see statements such as "company misunderstood by the market" (Parkfield), "company contemplating MBO" (Polly Peck) or "company seeking to realise shareholder value" (Cairn Energy).

Warning signs

Following on from this, companies give out very noticeable signals when they get into difficulties. The colourful diversions that clouded investors' judgement fall away like feathers from a moulting peacock. Companies stop returning phone calls from anxious investors, frequently presaging a profit warning or rights issue (eg Parkway, Westbury). They start attacking broking analysts who publish critical research (Coloroll) and threaten them with legal action (an analyst at Phillips & Drew left his job two days after issuing a critical note on the Maxwell Corporation).

Nadir: propped up the share price.

At the depth of their troubles the company may resort to changing its name (Systems Reliability) or the year end (Maxwell) or both if they are really desperate (Hodgson Holdings). This serves to confuse the investor and hamper his ability to assess the value of the company. The accounts of these companies become useless as a valuation tool.

Company accounts

Which leads us on to what to watch out for in company accounts that may indicate impending doom. Sometimes the mere style of the accounts roars out "this company is out of touch with reality". WPP's 1988 accounts were 183 pages long while the financial figures lost somewhere in the middle of this *magnum opus* were a mere 22 pages long. The 1989 accounts for WCRS, the advertising company, featured the senior members of the board flying across the pages from trampolines with pained expressions on their faces. The stock fell by 67 per cent over the following two years.

On the more serious side, the sale and leaseback of properties indicates cash flow problems. Large deferred tax provisions indicate that paper profits recognised this year were not matched by a cash inflow. Stocks falling dramatically with a commensurate rise in debtors may suggest year end stock sale and repurchase agreements that flatter liquidity (Parkfield indulged in this).

The pattern of debt is important; a preponderance of short-term borrowings/ overdrafts usually indicates imminent problems. Swiss franc or Deutschemark denominated borrowings without underlying local subsidiaries might indicate interest rate arbitrage (Polly Peck).

Look closely at the declarable shareholders list. Unusual holders with names such as 69 Banana Corp or Z27 Slushy Fund, may be the offshore accounts of directors who have been buying, supposedly as a third party, to try and prop up the share price (Polly Peck/Maxwell). Alternatively it may be another company that sold a poorly performing business to the company (Control Securities). Be wary when banks sell declarable holdings in companies; it may be the collateral held for loans to the company's director as in the case of Ferranti and Polly Peck. Banks usually have far better information than investors.

A note right at the end of the accounts entitled "contingent liabilities" often tells an interesting story. The downfall of British & Commonwealth and Coloroll could have been foretold from this simple note. B&C dramatically understated its liabilities at Atlantic Computers, indicating a £3m liability for its Flexi-leases when the true liability was more in the order of £300m. Coloroll gave guarantees to a number of Crowther businesses that it sold which went bust within months of the sale. The bank guarantees pushed Coloroll under.

Acquisitions

Often problem companies have expanded aggressively through acquisition. Look for what percentage of turnover acquisitions in the past year account for. VPI bought Carter in the US at the height of the bull market in 1987, and it immediately accounted for 60 per cent of profits with a large amount of deferred consideration. The vendor suddenly changed his mind about the future consideration he was to receive, demanding cash instead of shares. When VPI's finance director went out to the US to discuss this Mr Carter locked him in the boardroom (which contained a large tank of piranhas) and started fiddling with a large calibre revolver on his desk, to ensure a harmonious atmosphere for the discussions. The company collapsed within a year and Carter is in jail for fraud.

Deferred consideration

Deferred consideration has brought about the downfall of many companies. At one

point WPP had £130m outstanding to vendors who, after the monumental collapse in WPP's share price, became the proud owners of large declarable stakes. Always ensure that the deferred consideration on acquisitions has been capped (ie, the multiple of following years' profits to be paid is limited). IFICO (a miscellaneous financials company) bought a property developer in 1987 on uncapped deferred consideration. In the following year the vendor busily set about selling all the assets of the subsidiary, boosting profits to such an extent that the deferred consideration bill he presented to the board was higher than the pre-tax profit of the whole group.

Bullies

One could write a book about warning signs given off by management but the feature that should give most alarm is the boss being a bully. This character has been responsible for most of the spectacular crashes; he combines the role of chairman and chief executive, he attends publicity meetings alone and uses many myths to support his arguments. Maxwell was a well known bully while Ashcroft at Coloroll stood up at an investors' meeting and demanded that a broker's analyst leave the room as she had criticised the company.

Vanity of the management often unmasks the problem company. The much publicised winning of awards such as the Guardian Businessman of the Year or the USM dinner awards often preceded a rapid decline in the company's fortunes (Parkfield). Dickie bows are common amongst the clients of Cork Gulley (Roger Levitt, the flamboyant financial salesman, Peter Goldie at British & Commonwealth) reflecting their unique entrepreneurial skills and desire not to conform.

We all have fond memories of the seriously rich chief executive of a certain funeral company who turned up for analysts' meetings in sunglasses, sporting shoulder length dyed hair and pink short sleeve shirts. That stock has been a very poor performer. Another chief executive, who presided over an 80 per cent fall in his share price recently, always wore an elegant toupee to analysts' meetings. Analysts in cahoots would sit themselves at opposite ends of the meeting room and ask questions rapidly, alternating between the two, the prize going to the analyst who could displace this gentleman's toupee.

The market

Turning to signs that stock prices give us, managements got very indignant throughout last year each time their share price fell as a result of rumours (eg Lonrho). These "bear squeezes" as they became known were widely attributable to one Evil Knievil. I am sure that the directors who protested so loudly were as surprised as the rest of us when the rumours came true (no irony intended). A point to bear in mind about another common phenomenon, the profit warning, is that, like the first Labour general election defeat, it is seldom the last. MTM had seven profit warnings in 2 months, knocking the price from 287p down to 30p.

Director share sales can precede the share price abseiling down the north face of the Eiger. Investors are assured by the board that there is every good reason why the directors are bolting for the door and why investors should not contemplate following. On the day before the share sale there are heated exchanges in the board room while the directors slug it out over the best excuses for the share sales; the chief executive might get the divorce one, the finance director the capital gains tax liabilities one while lower entities have to settle for the lame buying a house or school fees one. At the following sale these excuses can be interchanged.

The most celebrated example of the

Levitt: partial to Dickie bows.

above is Yellowhammer, the advertising company. The chairman sold £3.5m worth of shares to improve the marketability of the company's shares! Within months the company was bust. Howard Hodgson, chief executive of Hodgson Holdings, sold 12 per cent of the company at 116p before the price collapsed to 42p. Peter Gummer at Shandwick sold £1.8m to his employees' share option scheme. The share price immediately halved and he was forced to renegotiate the price down.

Good news is bad news

Very often what appears on face value to be good news can be bad news dressed up. Recently the company director at Davies & Newman (the parent of Dan Air) was featured in a newspaper as saying that contrary to expectations he would be staying on at Davies & Newman because he enjoyed the challenge. Shareholders were chuffed and the share price rose 10p. Later that week their final results came out which disappointed, the accompanying statement said that substantial work remained to be done, the share price immediately retreated.

In 1988-9 a lot of companies made a big fanfare of signing up substantial Multi Option Facility syndicated loans, waxing lyrical about the golden age of opportunities ahead of the company. These MFO's are now the most common cause of crises at companies (Scottish Metropolitan, Priest Marians) due to their demanding covenants. Also note that the changing of financial advisers/brokers often precedes an unpopular rights issue or setback.

Many broking analysts confidently recommend buying poorly performing stocks and often the investing public follow this advice. Having worked my way through the files on Coloroll, Polly Peck, Ferranti and so on it is difficult to find a single sell note and I certainly didn't find any post-receivership analysis by the brokers of what went wrong. Once an analyst reassured me about Polly Peck saying that he had taken the accounts apart and found nothing amiss. Bitter experience was to prove to me his version of taking the accounts apart must have been to take the staples out of the accounts and let the contents fall on the floor.

The future

Much work is currently taking place that will prevent some of the more monumental crashes happening again. The ASB is making creative accounting more difficult.

From my experience there are two basic mantras to be learned by rote by all investors:

A. never complacently take the word of dubious management; and

B. start to read accounts from the back page (contingent liabilities, fair value adjustments, etc). This is the information the company would prefer you didn't read.

The warning signs: Top 10

1. Dickie Bows, gold ID bracelets, toupees and sun tans.
2. Sumptuous HQ buildings.
3. Substantial acquisition programmes with large deferred considerations.
4. Bullies holding the position of chairman and chief executive.
5. Changing year end/name.
6. Multi Option Facility syndicated loans.
7. The bear squeeze and the profit warning often precede a sustained downward trend.
8. Directors share sales.
9. Reliance on creative accounting.
10. The resignation of directors.

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