On avoiding Enron-itis!

by Mohnish Pabrai

Enronitis, unfortunately, is a widespread disease. Most of the companies that have it are yet to be recognized by the financial press. How is the investor to avoid these minefields?

Let's delve into some of the symptoms of Enronitis and how to recognize them:

1. Obtuse Financial Statements

"The only reason that one may not understand a financial statement is because the writer does not want you to understand it."

- Warren E. Buffett

When Buffett encounters an obtuse financial statement, he simply abandons his research on the given company and moves on to looking at the next business. There are thousands upon thousands of public companies. If you encounter one that's within your circle of competence, but the financial statements confuse you rather than crystallize your view of the business, simply abort your research and move on to the next one.

2. Consistency of Business Performance

"At GE, Jack Welsh is ever devoted to increasing earnings per share. One year earnings were really down except for an adjustment to the assumptions under the pension plan and the liquidation of a LIFO reserve that very conveniently produced up earnings instead of down earnings. Of nine securities, only one noted that fact. Eight of nine was not bad. Jack was a winner on that one."

- Louis Lowenstein, Columbia University Law School, Cardozo Law Review, Sept.-Nov. 1997

The market rewards companies with consistent, predictable earnings with a robust valuation. Most well meaning CEOs think it is their fiduciary duty to maximize the stock price and hence try to deliver everything the street wants in the pursuit of their "duty". The CEOs duty is not to maximize the stock price but rather to maximize the intrinsic value per share of stock. GE's obsession with highly consistent earnings is a result of their leadership associating GE's stock price as a barometer for the success of the company.

Businesses are not CDs. They exist in the real world and, with the exception of a infinitesimally small minority of businesses, their earnings will not naturally rise every single year. So, to avoid Enronitis, look at a long history of reporting earnings for a given business. If it has been increasing every year in a highly consistent manner, that is a big clue to stay away. There are a few exceptions, but they are obvious. I expect Paychex to increase revenues and earnings annually because of their highly consistent recurring revenue model. I do not expect to see it at companies like American Express, GE or Berkshire Hathaway.

3. "Restructuring" Charges

It has become commonplace for companies to take "onetime" restructuring charges and emphasize their numbers before the charge. Berkshire Hathaway has been through numerous restructurings. They were only in textiles and eventually exited textiles. They lost a lot of money acquiring Dexter shoes etc. Management could have opted to describe the associated charges as onetime, non-recurring costs and painted a better earnings picture. Instead Berkshire has always expensed these costs on their income statements as the normal cost of doing business.

When you see a company report restructuring charges, especially the ones that "clean house" every few years, be very very skeptical and redo the numbers taking those charges as normal business costs. To me it means that I'm dealing with management whose ethos is nowhere near where I'd like it to be – and thus I avoid them like the plague.

4. Earnings Guidance

Earnings guidance is another indicator of Enronitis. When I ran an IT Services company (TransTech), it was relatively small (under $20 Million) and had a highly predictable revenue stream. Even with those characteristics, I could not predict what the cash flows or profits from the business would be 3 months, 6 months or a year in advance. Yet, companies as complicated as GE routinely are able to predict – down to the last cent - what the business will earn a year in advance! I must have been a stupid CEO who could not even do this simple calculation for my company!

Here are Buffett's succinct comments on the subject of earnings guidance from the 2000 Letter to Shareholders of Berkshire Hathaway:

"Over the years Charlie and I have observed many instances in which CEOs engage in uneconomic maneuvers so that they could meet earnings targets they had previously announced. Worse still, after exhausting all that operating acrobatics would do, they sometimes played a variety of accounting games to "make the numbers". These accounting shenanigans have a way of snowballing: Once a company moves earnings from one period to another, operating shortfalls that occur thereafter require it to engage in further accounting maneuvers that must be even more "heroic." These can turn fudging into fraud. More money, it must be noted, has been stolen at the point of a pen than at the point of a gun."

Regulation FD has stopped, for the most part, the private conversations between management and analysts on guidance etc. Much of this is out in the open now – which is good. However, we have a long ways to go before 90+% of public companies cease providing any sort of earnings guidance. Most of the companies in my portfolio do not offer guidance and I'd be happier if none of them did. When management of non-predictable businesses nonchalantly offers earnings guidance that's a big hint to stay away.

5. Related Party Transactions, Compensation and Stock Options

Company 10-K's and 10-Q's are required to lay out a section usually called "Related Party Transactions." This is where there is disclosure of transactions between the company and its officers or board members. With Enron, this was a big part of the problem. Related Transactions of any kind are usually problematic and signal low ethos and a company that does not have a shareholder centric view of the world. If you see stuff here that you don't "get", just stay away. Ideally, there should be no transactions to mention.

It's worth studying the proxy statement for compensation data. I want to see management well rewarded for delivering the goods. When you study option grants, bonuses and base salaries, consider whether you're comfortable with the numbers given the performance of the business and management.

6. The Nature of Management

When I am beginning to look at a company, my starting point is Item 1 in the 10-K which describes the business. If this description does not give me a solid feel for the business, I usually stop right there and exit. In my opinion, any business can be explained to a layman in 2-3 pages at most. Usually it should take no more than a paragraph. If it's obtuse then, like accounting statements, I perceive management as being deliberately obtuse and exit.

If the description makes sense, then before reading the rest, I listen to the most recent conference call. I am more interested in the nature of management than what they are saying. I try to gauge their shareholder orientation and ethos from the way they run the call. What do the CEO and CFO emphasize? How do they handle the Q&A? How candid are they? Are they genuinely trying to help the listener gauge the reality of the business? After the call, if I feel great about "partnering" with the management team, I'll spend several days building a mental model about the future based on data from the company and others, past knowledge and experience before making a decision to move forward.

To summarize, if seven moons don't line up, I don't make the investment. Avoiding Enronitis is simple, but not necessarily easy. It takes determination, discipline and one must enjoy kissing lots and lots of frogs to find the rare prince.

Mohnish Pabrai is the Managing Partner of Pabrai Investment Funds. He can be reached at mohnish@corp.siliconindia.com