

From the CIO'S Desk



CHANGING OF THE GUARD: MINORITY SHAREHOLDERS, STAY VIGILANT.

Visualize a car racing at a high speed. Now, imagine a manoeuvre where a new driver replaces the old one while the car is still running. The operation is fraught with risk, and to complete it successfully, you require skill of a high order and a bit of luck. The risks of losing control, skidding, the vehicle going off course, and a possible accident are real.

While the car example is exaggerated, minority shareholders face a somewhat similar risk when top management changes in their investee companies. Unlike sponsors/promoters directly involved in the decision to change the driver, the fate of the minority shareholders remains like that of backseat passengers who are not in control but get impacted, nonetheless.

Corporate history is replete with examples of significant changes in the trajectory of a company's business and stock price after a management change. During this transition period, investors (both existing and potential) need to stay alert. The need to remain vigilant is even more pressing in asset-light businesses, where top management can alter strategy relatively swiftly compared to asset-heavy businesses.

The context of management change in each case is unique and must be analysed separately. However, let's briefly touch upon high-profile situations on either side of the spectrum that generate huge interest among market participants:

A successful boss leaving a leading company:

High relative stock valuations (vis-a-vis industry peer group & broader market) enjoyed by many leading companies are often a result of past consistent & superior operating performance. Over time, investors come to expect (sometimes bordering on faith) that it will continue forever. The result is often a halo effect and a valuation premium, which is hard to explain using fundamental parameters.

Management change in such an enterprise typically presents an unfavourable risk-reward equation for investors. While the new management may proclaim to continue the same path, there is a real danger that speed and/or direction may change, causing disappointment and eventual derating of the stock.

A reputed manager joining a lagging company:

Low relative stock valuations suffered by many laggards are often a result of consistently subpar operating performance. Change of management in this kind of company, especially the arrival of a top boss with a proven track record, can create a lot of excitement and narrative building. The result is often a big re-rating of the stock even before the new boss joins and begins to make any changes. At this stage, the risk-reward offered by many of these stocks becomes unfavourable.

It is better to be cautious in these situations and not get carried away by the narrative. Investors should remember Warren Buffett's famous quote: "When a manager with a reputation for brilliance tackles a business with a reputation for bad economics, the reputation of the business remains intact."

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