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Multinationals in India: Breeding corporate royalty

The CNX MNC Index has outperformed the CNX Nifty over the past five years: but does that allow parents of multinational companies (MNCs) in India to dip into the cashbox and take as much royalty as they please?

The top five royalty payouts in 2014-15 (Maruti, HUL, ABB, Nestle and Bosch – in that order) aggregated Rs.47.7 bn (Table 1 on page 2), up from Rs.42.5 bn in 2013-14. Royalty payouts were 24% of aggregated pre-tax pre-royalty profits and 4.4% of aggregated net sales of these five companies for 2014-15.

In a recently published report titled 'Royalty flows in Suzuki's blood', IiAS demonstrated that, over a 15-year period, Maruti's royalty payouts to Suzuki outpaced revenues, per car realizations, profits (pre-tax pre-royalty), and Suzuki's R&D spends. In 2014-15 alone, Maruti's royalty payments aggregated Rs.27.7 bn or 5.7% of net sales and 36% of pre-tax pre-royalty profits. Over the past 15 years, royalty paid to Suzuki, has grown 6.6x, while average sales realization per car has increased only 1.6x. Although Suzuki's consolidated R&D spend per vehicle (including motorcycles) averaged 4% of sales, its royalty payments from Maruti are 6% of net sales.

A contrary view published by a Financial Express editorial was that shareholders have got a good return on their investments. Maruti's stock price has trebled between March 2010 and September 2015, despite high royalty payouts, and the stock trades at a multiple of 35x which is higher than peers. This is a simplistic argument. A simplistic rebuttal would be: if the MNC stock prices falls, or its trading multiple reduces, do investors expect the company to reduce royalty payouts? And if MNCs make losses, should no royalty be paid? Compare EPS growth with increase in royalty: in Maruti's case, Maruti's basic EPS has grown 4.16x over the past 10 years, while its royalty expenses (in absolute amounts, including annual amortization of lump sum royalty) have increased 13.94x, and royalty spend per car has increased 5.78x.

The question to ask is, what is the royalty being paid for?

For a company like Maruti that lost its supremacy with the entry of other MNCs in the automobile segment, how strong indeed is Suzuki's product portfolio? Maruti may be the largest automaker in India today, but it has been losing market share. From market dominance in the late 1990s, Maruti's market share dropped to 38.3% in 2011-12[1] as the market shifted towards sedans: Maruti has clawed back its market share over the past three years to 45%[2] in 2014-15. Despite this, Maruti pays out the highest amount of royalty (in absolute terms) of all MNCs in India.

Take Nestlé as another example: Nestlé India is one of India's top 5 royalty-paying MNCs. In 2014-15, Nestlé India paid out royalty aggregating Rs. 4.2 bn. Nestlé India pays royalty for Nestle's intellectual property rights including global portfolio of brands, proprietary science and technology including over 1,300 patents, extensive research and development capabilities and expertise on best practices. But where

[1] *Source: Maruti's 2012-13 Annual Report*
[2] *Source: Maruti's 2014-15 Annual Report*

was the global parent when the Maggi row began? Though the charges were unwarranted, its response was flat-footed – in contrast to how Cadbury dealt with a product quality issue. It was only after the international media picked up the issue that Nestlé's global management began to react, but by then the issue had snowballed. Did the global parent not bear responsibility in managing the brand in India?

The Maggi brand of noodles has lost its dominance – the off-the-shelves time has allowed other players to capture consumers' taste buds. The Nestlé brand too has taken a beating in the Indian markets. Will Nestlé continue to increase royalty by 0.2% in 2015-16 as well? According to the 2013 revision in terms, royalty would increase by 0.2% of sales annually for five years, beginning 1 January 2014. If it does, this will squarely establish that royalty payouts don't need a reason or a rationale – they are merely coercive handouts to exacting global parents.

Table 1: Top five royalty paying companies

Company Name	Financial Year	Royalty paid (Rs.bn) (Latest)	Royalty % of Net Sales (Latest)	Royalty as % of PAT (Latest)	Royalty as a % of (Royalty + PAT)
ABB India Ltd.	2014	4.9	6.3%	212.9%	68.0%
Maruti Suzuki India Ltd.	2014-15	27.7	5.7%	74.6%	42.7%
Nestle India Ltd.	2014	4.2	4.2%	35.1%	26.0%
Bosch Ltd.	2014-15 (Annualized)	3.6	3.9%	33.0%	25.3%
Hindustan Unilever Ltd.	2014-15	7.4	2.4%	17.1%	14.6%

Given the past history of royalty payouts, regulations should compel royalty payouts to be approved by shareholders. Requiring shareholder approval will oblige companies to explain the basis of charging royalty and be more considered in its decision-making. Today, companies do not explain the basis of charging royalty. If the terms of royalty are changed, the revised royalty percentages are announced. But how are these arrived at? How did the companies establish that these are being paid at arm's length? Maruti, for example, increased its royalty payouts to account for the Rupee-Yen exchange rate fluctuations – but, why did Maruti's board cave into absorbing all the exchange losses?

As in the case with Maruti, a good stock price run tends to right all the wrongs for the company and the investors. But even during the good times, there is an opportunity loss in terms of EPS in companies that payout extortive royalties. Investors must engage with MNCs in India and actively push them to rationalize royalty payouts.

A modified version of this article was published as a column by Amit Tandon in the Financial Express dated October 27, 2015

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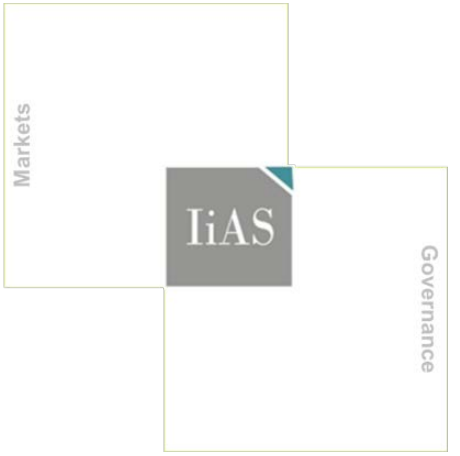

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