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Royalty payment: Establishing its legitimacy

Royalty payments have been a bone of serious contention, enough to bring in regulatory intervention. In most instances, royalty is a legitimate charge for the company, but how much is enough?

While MNCs have been paying royalty to their parent companies for the use of brands and technological support, Indian promoters too have been charging listed companies for the use of the brand. Investor pressure has resulted in SEBI bringing in regulations for royalty payments above 2% of net sales to require shareholder approval – one of the many recommendations of the Kotak Committee (that was modified by SEBI in its final acceptance). Royalty payments carry different nomenclature – sometimes these are charged in the name of brand fees or technical know-how fees, or other service-related fees.

The regulatory intervention was much needed. In several instances, royalty payments made by Indian companies needed to be justified. In February 2019, [Jubilant FoodWorks Limited had to withdraw its decision to pay royalty](#) to promoters just a few hours after making the announcement following immediate investor push-back. [Havells' promoters were paid royalty for the brand up until April 2016](#) despite the company itself bearing advertisement and other brand building costs. The Singh brothers (erstwhile promoters of Fortis Healthcare Limited) announced that the over Rs. 5bn recoverable from them would be adjusted against royalty for the Fortis brand.

On the other hand, the Tata Group¹ has signed a [brand equity agreement](#) with its group companies where, depending on the degree of usage of the Tata brand, the royalty payouts from group companies will be restricted to a specified percentage of turnover. These payouts are restricted to a maximum of Rs.750 mn and 5% of profits – ensuring that the fees are not excessive and are linked with operational performance. In case Tata companies make losses, they are not required to pay brand fees to Tata Sons. This brand equity agreement is publicly available and lists out Tata Sons' responsibility towards brand building. Tata Sons has a well-organized function that manages the Tata brand.

Multinationals (MNCs) in India pay royalty because they bring brands that have been developed globally to India. To be fair, those brands do carry market value and are able to attract customer loyalty. But to what extent should royalty be paid? The quantum of royalty paid by MNCs has been egregious in the past, [tempering only over the past two years](#). In the

¹ Disclosure: The Tata group, through Tata Investment Corporation Limited, is one of IiAS' shareholders.

financial year ending in 2018, 27 MNCs² paid an aggregate of Rs. 67.37bn in royalties, more than half of which is accounted by [Maruti Suzuki India Limited](#) at Rs. 38.18 bn. The Rs. 67.37bn royalty payment accounts for 16% of these 27 MNCs pre-tax pre-royalty profits and almost 27% of their aggregate Rs. 250.40 bn profit after tax. Maruti Suzuki India Limited, GE T&D India Limited, 3M India Limited, and Johnson Control-Hitachi Air Condition India Limited have paid more than 20% of their pre-tax pre-royalty profits as royalty to their parent company. 14 of the 27 MNCs (whose recent financial statements were available) have paid over 2% of net sales as royalty to their parent company.

Although royalty payments are related party transactions, they earlier escaped shareholder approval since these did not exceed 10% of revenues or net worth. Companies maintain that royalty payments are in the ordinary course of business (in several instances that is so) and on arm's length terms (which is debatable). Given how high these payouts were in some companies, and the significant investor push back over not having oversight on these payments, the Kotak Committee recommended that such payments be brought for a separate shareholder approval –the Kotak Committee set a threshold of royalty payments in excess of 5% of revenues, SEBI while accepting the recommendation decided to lower the threshold to 2% of revenues. Shareholder approval is required for payments made from 1 April 2019 onwards³.

The question is how should shareholders vote on such resolutions when these are presented? Likewise, what disclosures should companies make while asking for shareholder approval? Here, are a few issues to address:

1. Should the company be paying royalty in the first place?

This question pertains to domestic companies more than MNCs. Investors need to question whether there is a need to pay royalty in the first place. Where companies themselves pay for brand development or the company is itself synonymous with the brand, the rationale to pay promoters for the brand must be questioned. More importantly, for recipients of the royalty or brand fee must be able to justify what they are doing to create or develop the brand. And this should include technology: Nestlé spent CHF1.7 billion (Rs 119.7 bn) on R&D. Looking at royalty as a mere charge for ownership of the brand must be avoided. Specific questions that must be answered are:

- When was the brand registered?

² Schaeffler India Limited, Castrol India Limited, and ABB Limited all pay royalty to their parent companies. However, these are yet to publish the FY18 annual reports. Therefore, their data has not been included in this assessment.

³ The need for shareholder approval has now been deferred to 30 June 2019.

- Why was the brand not registered in the company's name itself?
- When was the royalty agreement first signed?
- How much does the company spend on the advertisement and brand building?
- How does the recipient use the royalty or brand fees? Is there a structure around spending on brand development?

2. Does the market see value in the brand/technology?

Brands that have a strong franchise must be able to command faster sales growth than competitors, or be able to command better product margins, or both. Therefore, while assessing whether there is value in the brand, investors must ascertain if the company has been able to outperform its peers within the same industry – either on revenue growth or on margins – on a consistent basis. For recently introduced brands, one could argue that their acceptance in the Indian market is largely because of the brand (Starbucks, Mercedes-Benz, Oral-B); even so, royalty payments must not begin immediately, but after the brands have established themselves locally as well. Specific questions that must be answered are:

- Does the company have an almost monopolistic position in the market or are there several competitors in the market?
- Has the brand / company developed a certain size to become comparable to peers, or does it remain a niche player in the industry?
- Has the company outperformed its peers on revenues or profit margins?

3. How has the quantum of royalty been decided?

Companies have decided on royalty payments as a percentage of sales and profits. But in several cases, it is unclear how the number has been arrived at. Companies must disclose the basis of the royalty charge, and as a good practice have either a cap on the absolute quantum or seek periodic review of royalty terms from shareholders or both. MNCs charge royalty from other markets – therefore, clarity on the comparability of the royalty to be paid by the Indian entity vis-à-vis the region is an equal determinant of its legitimacy. Having independent brand valuers, with oversight by the audit committee, makes the proposition more convincing. Specific questions that must be answered are:

- Will the royalty agreement be periodically reviewed (every 5 years at the very least) or is the agreement in perpetuity / to be reviewed at the parent company's / promoter's insistence only?
- How has the royalty been determined? Is it a share of revenues, profits, or on specific product lines?
- Is there a cap on the aggregate royalty that will be paid out?
- For MNCs, is the royalty being charged to the Indian company comparable to that charged by the global parent in other Asian markets?
- Is there an independent (third party) evaluation of the terms of royalty? Has the audit committee of the Indian company got its own independent advisor to assess the appropriateness of the terms of royalty?

As resolutions get presented to shareholders over the next few weeks, both investors and companies would be well placed in greater transparency and better disclosure. Investors understand the value of brands and are unlikely to oppose such payments – unless the quantum is much too high or the payout is simply unjustified. Asking for periodic approval from shareholders is important – shareholder approvals or agreements in perpetuity (Castrol India Limited and Nestlé India Limited) are unlikely to be supported by all investors. Most of all, companies need to engage with investors and discuss their perspectives on royalty.

*A modified version of this article was published on www.moneycontrol.com.
The article can be accessed here: <https://bit.ly/2UkhtHu>.*

Exhibit 1: Royalty payments made by MNCs in the financial year ending in 2018

(Amounts in Rs bn)

Company Name	Year end	Net Sales	PBT	PAT	Royalty	Royalty / (PBT + Royalty)	Royalty / Net sales
3M India Limited	31-03-18	25.56	4.80	3.11	1.34	21.8%	5.2%
ACC Limited	31-12-18	148.01	14.94	15.07	1.45	8.8%	1.0%
Akzo Nobel India Limited	31-03-18	29.65	5.42	4.01	0.84	13.5%	2.8%
Ambuja Cements Limited	31-12-18	109.77	15.06	14.87	1.09	6.8%	1.0%
BASF India Limited	31-03-18	53.60	2.61	2.47	0.49	15.9%	0.9%
Bata India Limited	31-03-18	26.29	3.40	2.24	0.27	7.3%	1.0%
Bosch Limited	31-03-18	112.11	20.41	13.71	2.12	9.4%	1.9%
Colgate-Palmolive (India) Limited	31-03-18	41.88	9.83	6.73	1.85	15.8%	4.4%
Cummins India Limited	31-03-18	50.83	9.08	7.08	0.53	5.5%	1.0%
GE Power India Limited	31-03-18	13.38	0.42	0.27	0.10	18.6%	0.7%
GE T&D India Limited	31-03-18	43.32	3.19	2.09	1.03	24.5%	2.4%
Gillette India Limited	30-06-18	16.77	3.45	2.29	0.10	2.9%	0.6%
Grindwell Norton Limited	31-03-18	14.05	2.22	1.47	0.28	11.2%	2.0%
GSK Consumer Healthcare Limited	31-03-18	43.17	10.74	7.00	1.44	11.8%	3.3%
Heidelberg Cement India Limited	31-03-18	18.90	2.08	1.33	0.17	7.6%	0.9%
Hindustan Unilever Limited	31-03-18	345.25	72.85	52.37	6.96	8.7%	2.0%
Johnson Control-Hitachi Air Condition India Limited	31-03-18	21.85	1.51	1.00	0.51	25.1%	2.3%
Kansai Nerolac Paints Limited	31-03-18	45.87	7.86	5.16	0.18	2.2%	0.4%
Maruti Suzuki India Limited	31-03-18	797.62	110.03	77.22	38.18	25.8%	4.8%
Monsanto India Limited	31-03-18	6.63	1.71	1.65	0.11	6.2%	1.7%
Nestlé India Limited	31-12-18	112.16	24.29	16.07	4.93	16.9%	4.4%
Procter & Gamble Hygiene & Health Care Ltd.	30-06-18	24.55	5.82	3.75	1.20	17.1%	4.9%
Schneider Electric Infrastructure Ltd.	31-03-18	13.14	-0.65	-0.65	0.20	-45.9%	1.5%
SFK India Limited	31-03-18	27.50	4.56	2.96	0.79	14.7%	2.9%
Timken India Limited	31-03-18	12.34	1.40	0.92	0.25	15.2%	2.0%
WABCO India Limited	31-03-18	25.69	3.82	2.73	0.77	16.7%	3.0%
Whirlpool of India Limited	31-03-18	48.32	5.41	3.51	0.21	3.8%	0.4%

Source: Annual reports, ACE Equity, IiAS Research

Note: Schaeffler India Limited, Castrol India Limited, and ABB Limited all pay royalty to their parent companies. However, these are yet to publish the FY18 annual reports.

Exhibit 2: Royalty payments made by MNCs in the financial year ending in 2017

(Amounts in Rs bn)

Company Name	Year end	Net Sales	PBT	PAT	Royalty	Royalty / (PBT + Royalty)	Royalty / Net sales
3M India Limited	31-03-17	23.63	3.69	2.41	1.25	25.3%	5.3%
ABB Limited	31-12-17	90.87	6.22	4.20	7.12	53.4%	7.8%
ACC Limited	31-12-17	129.09	12.98	9.15	1.28	9.0%	1.0%
Akzo Nobel India Limited	31-03-17	28.25	3.42	2.47	0.76	18.1%	2.7%
Ambuja Cements Limited	31-12-17	102.40	16.19	12.50	1.03	6.0%	1.0%
BASF India Limited	31-03-17	50.85	-0.12	-0.14	0.44	140.0%	0.9%
Bata India Limited	31-03-17	24.67	2.34	1.59	0.27	10.4%	1.1%
Bosch Limited	31-03-17	101.76	20.94	17.41	1.64	7.3%	1.6%
Castrol India Limited	31-12-17	35.84	10.70	6.92	1.06	9.0%	3.0%
Colgate-Palmolive (India) Limited	31-03-17	39.82	8.51	5.77	1.86	17.9%	4.7%
Cummins India Limited	31-03-17	50.77	9.08	7.35	0.51	5.3%	1.0%
GE Power India Limited	31-03-17	19.93	0.28	0.00	0.28	49.6%	1.4%
GE T&D India Limited	31-03-17	40.52	-0.73	-0.87	0.94	456.9%	2.3%
Gillette India Limited	30-06-17	17.34	3.74	2.53	0.11	3.0%	0.7%
Grindwell Norton Limited	31-03-17	11.59	1.73	1.16	0.18	9.6%	1.6%
GSK Consumer Healthcare Limited	31-03-17	39.86	10.10	6.57	1.47	12.7%	3.7%
Heidelberg Cement India Limited	31-03-17	17.17	1.14	0.76	0.17	13.0%	1.0%
Hindustan Unilever Limited	31-03-17	318.90	63.96	44.90	7.09	10.0%	2.2%
Johnson Control-Hitachi Air Condition India Limited	31-03-17	19.72	1.18	0.81	0.45	27.7%	2.3%
Kansai Nerolac Paints Limited	31-03-17	39.99	7.59	5.06	0.16	2.1%	0.4%
Maruti Suzuki India Limited	31-03-17	680.35	99.41	73.38	39.69	28.5%	5.8%
Monsanto India Limited	31-03-17	6.41	1.59	1.48	0.08	4.7%	1.2%
Nestlé India Limited	31-12-17	99.53	18.39	12.25	4.17	18.5%	4.2%
Procter & Gamble Hygiene & Health Care Ltd.	30-06-17	23.20	6.72	4.33	0.99	12.9%	4.3%
Schaeffler India Limited	31-12-17	19.87	3.62	2.38	0.45	11.1%	2.3%
Schneider Electric Infrastructure Ltd.	31-03-17	12.65	-1.60	-1.60	0.23	-16.4%	1.8%
SFK India Limited	31-03-17	26.31	3.76	2.44	0.68	15.4%	2.6%
Timken India Limited	31-03-17	10.56	1.38	0.97	0.21	13.4%	2.0%
WABCO India Limited	31-03-17	20.67	3.00	2.13	0.80	21.0%	3.9%
Whirlpool of India Limited	31-03-17	39.41	4.68	3.10	0.39	7.7%	1.0%

Source: Annual reports, ACE Equity, IiAS Research

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Office

Institutional Investor Advisory Services
Ground Floor, DGP House,
88C Old Prabhadevi Road,
Mumbai - 400 025
India

Contact

solutions@iias.in
T: +91 22 6123 5509/ +91 22 6123 5555