Royalty payments and minority shareholders

In the December of 2009, the government of India, through press note 8, liberalized the payment of foreign technology collaborations and royalty fees under the automatic route (- including lump sum payments for transfer of technology, payments for the use of trademark and brand name). The liberalization of the Foreign Technology Agreement Policy was aimed at facilitating inflow of foreign direct investment and technology transfers into the country. Foreign partners would now no longer have to go through administrative hoops. Importantly this meant that 'foreign sponsors' who earlier required government approval for charging royalty under the various heads were now free to charge any amount as royalty to their Indian subsidiaries (- refer table 1 below).

Table 1: Restrictions pre and post liberalising royalty payments:

Type of payment	Condition	Pre-Press Note 8 (2009 series)	Post-Press Note 8 (2009 series)
Lump sum payments	Under technical collaboration	< US$ 2 million	No limit
Royalty payable	Under technical collaboration	8 % on export and 5% on domestic sales	No restrictions - subject to FEMA (Current Account Transactions) Rules, 2000
Royalty payable	For use of trademark and brand name of the foreign collaborator	2% of exports and 1% of domestic sales	No restrictions - subject to FEMA (Current Account Transactions) Rules, 2000

The unintended consequences of waiving restrictions on royalty payments can be seen from the gradual increase in technical know-how, royalty, consultancy fees etc. by foreign partners since 2009, without a commensurate increase in either sales or margins. Note that for the purpose of this analysis we have used the term royalty to include royalty, know-how fees, technical fees, license fees and IT charges.

An analysis of the key financials of 25 Indian companies since 2007-2008 (- excluding the financial year encompassing December 2009) pre and post-issuance of press Note 8 shows:

- The three companies with the highest royalty remittance of Rs.2495 crores were remitting Rs.784 crores in 2007-08. While remittance has gone up 3.2 times, their revenues have gone up by only 1.8 times. Further the margins of two of the three companies have shrunk, suggesting that market does not attribute a similar value either to the technology or the brand.
- The top 20 royalty paying companies now remit Rs.3601 crores as royalty payments, up from Rs.1196 crores, five years ago. While royalty amounts have more than doubled, sales have grown by just over 70%.
- Total royalty for the 25 companies in the study has increased to Rs.3635 crores in 2011-12, up from Rs.1528 crores in 2007-08
- Four of the 25 companies have not paid any dividends in the last five years, but have paid royalty of Rs.385 crores since 2007-2008 (excluding one-off dividend payments).

Royalty Payments

The five highest royalty paying companies are shown in table 2 below.

Table 2: The five highest royalty paying companies

The Top 5 (Rs. Cr)	Royalty paid	
	2007-08	2011-12
Maruti Suzuki	493.1	1,803.1
ABB	146.9	374.9
Nestle	144.4	316.7
Hindustan Unilever	77.2	300.9
Bosch	28.6	129.1

Maruti Suzuki has consistently paid the highest royalty. The Rs.1803 crores paid in FY12, accounts for 5.2% of its net sales. In FY08, the company paid only 2.8% of sales (Rs.493 crores). The companies EBITDA margins have been on a downward trend from 17.5% in 2008 to 9.6% in 2012.

The mix of companies includes auto, FMCG, engineering and auto-ancillaries.

Royalty vs. PAT

The 25 companies under our analysis, at an average, paid about 25% of profits as royalty to foreign sponsors in FY12.

ABB and Maruti Suzuki topped the list with this ratio at over 200% and 100% respectively. Other companies such as Nestle India, Procter and Gamble, Alstom T&D and BASF India paid royalty to foreign sponsors in the range of 30% to 40% of net profits.

Data indicates that foreign sponsors are less concerned about the impact royalty payments have on the bottom-line of Indian subsidiaries. For instance, Asahi India Glass paid Rs.20.5 crores as royalty payments though it incurred a loss of Rs.58.7 crores in FY12.

Table 3: Royalty vs. PAT

Name of the company	Royalty/ PAT (%)
ABB	203.2%
Maruti Suzuki	110.3%
Alstom T+D	44.5%
Proctor and Gamble	31.4%
Nestle India	32.9%
BASF India	30.2%

Does higher royalty lead to higher growth and better margins?

BSE 100 companies have, by far, performed much better than the 25 companies under our analysis. Not only has the broad index companies outperformed these 25 companies in growth over the past 5 years, they have also reported better EBITDA margins. This raises the question, what are company's paying for if their local competitors are growing faster and earning higher margins.

Table 4a: Growth Ratios - BSE 100 vs. 25 companies

2008-2012	BSE 100	25 companies
Net sales growth	93.7%	78.1%
EBITDA growth	69.1%	36.4%
PAT growth	42.7%	33.2%

Table 4b: Margins - BSE 100 vs. 25 companies

Composition	BSE 100		25 companies	
Year	2008	2012	2008	2012
EBITDA margins	30.7%	26.8%	20.0%	15.3%

With Indian subsidiaries now having easier access to technology, know-how, use of brand names and trademarks, the revenues for these companies should have shown higher growth in comparison to the restricted-royalty era. However we find that YoY net sales have grown by just 100 basis points, EBITDA growth has dipped by a considerable 930 basis points, indicating that transfer of technology has not brought either more efficient manufacturing or higher realizations for the brand.

Table 5: Growth ratios of the 25 companies

Growth ratios (median values)	2007-08 to 2008-09 (Restricted-royalty)	2010-11 to 2011-12 (Unrestricted Royalty)
Net Sales YoY growth %	16.8%	17.8%
EBITDA YoY growth %	17.0%	7.7%

Royalty vs dividend

The average royalty paid by the 25 companies in our study has increased more than two-fold, while the dividend increase has been modest at 1.3 times. Again Maruti has the highest ratio of royalty to dividend at 5.5x. Maruti shareholders would have benefited by Rs.47.60 per share as dividend in FY12 alone, had the company paid the royalty amount as dividend.

ABB is the next highest at 3.5X. For FAG Bearings, Alstom T+D, BASF India this ratio ranges between 1.0x to 1.5x.

Table 6: Impact on dividend (Select companies)

Maruti Suzuki

Period&	Royalty related fees as a % of net sales	EBITDA Margins	Pay-out to Foreign partners = Dividend + Royalty per share	Dividend / share (Rs.)	(Dividend + Royalty)/ Share
FY12	5.2%	9.6%	123.8	8.7	56.3
FY08	2.8%	17.5%	37.3	5.9	17.7

Hindustan Unilever

Period&	Royalty related fees as a % of net sales	EBITDA Margins	Dividend/ share (Rs.)	(Dividend + Royalty)/ Share
FY12	1.4%	16.1%	8.7	9.8
FY08	0.6%	16.9%	10.7	11.0

What surprises is that companies such as 3M India, Timken India, Whirlpool of India and Asahi India Glass have paid royalty in the range of 1.2% to 2.6% of net sales to their foreign partners but have not paid any dividends to shareholders since 2008 (- excluding one-off dividend payments). Had these companies paid dividends in lieu of royalty payments to foreign partners since 2008, all shareholders could have enjoyed the monetary benefits. For instance, the shareholders of 3M India would have made Rs.13 per share for FY12 alone.

Companies that have increased royalty payments or have paid royalty but not dividends are listed in table 7.

Table 7: Companies paying royalty but no dividend

Whirlpool of India

All figures in INR (except %) Year	Pay-out to Foreign partners = Dividend per share + (Royalty related fees/ Shares held)	Dividend/ share (Rs.)	(Dividend + Royalty)/ Share
FY12	3.8	0.0	1.9
FY08	1.9	0.0	1.4

Asahi India Glass

All figures in INR (except %) Year	EBITDA Margins	Dividend/ share (Rs.)	(Dividend + Royalty)/ Share
FY12	11.4%	0.0	0.9
FY08	20.6%	0.0	1.3

Timken India

All figures in INR (except %) Year	EBITDA Margin	Dividend/ share (Rs.)	(Dividend + Royalty)/ Share
FY12	12.3%	18.6	20.5
FY08	20.7%	0.0	0.9

3M India

All figures in INR (except %) Year	EBITDA Margin	Dividend/ share (Rs.)	(Dividend + Royalty)/ Share
FY12	9.0%	0.0	13.0
FY08	18.5%	0.0	No Info

Moreover given the current withholding tax rate (dividend payments - 10%, royalty and technical services - 20%) companies would have lowered their incidence of tax in case they had paid dividends, rather than remit the money as royalty.

Disclosures

Companies often tend to club royalty related payouts with other expenses under a general banner.

For example, Ambuja Cements has classified the fees it pays to its foreign sponsor under 'Services Received' and payments relating to limestone and mining to Madhya Pradesh State Mining Department as 'Royalty'. Others classify payment to foreign sponsors as royalty. Implying royalty data across companies may not be comparable.

Standardizing the categories of payment will bring much needed clarity on this subject.

IIAS View

Since the rules have been eased, the multinationals have not behaved responsibly: They have been impatient, constantly pushing up royalty with little in the performance to justify this increase.

The ownership structure goes a long way in explaining why increase this in royalty payments is asymmetric to the increase in sales or margin. The managements that negotiate the royalty arrangements are employed by the company with whom they negotiate. Often they negotiate with their own bosses. This is not conducive to head butting.

As these are commercial arrangements, they do not come to shareholders to vote. And nor has the controlling shareholder ever felt the need for transparency by disclosing the rationale for such payments more clearly.

Prior to making such payments, foreign sponsors need clarify concerns that minority shareholders often have. For example, how does one quantify the technical know-how fees offered vis-à-vis the amount of royalty paid? Is the use of brand name and trademark actually driving up sales for the Indian companies? What impact has the latest know-how had on margins? Has the use of latest technology materially reduced expenditure on manufacturing related costs? It will bring clarity if companies compare details of what they pay (or propose to pay) with what their competitors and peers pay, and explain the rationale.

A few options should be explored include:

- Royalty payments may be made towards mining rights or as payment to the 'parent' for 'services' rendered – technology, brand, use of software etc. Clearly one is different from the other. Providing clarity on the nature of such payments, by standardizing the terminology, will shed greater light on what such payments are for.
- Such arrangements are voted upon by shareholders. This could be put to vote:
    - With either the majority of minority investors signing off on the arrangement.
    - Or through a special resolution requiring 75% approval from all shareholders voting.
- Companies should divulge the rationale of such payments and state costs and expected benefits (i.e. increase in sales or margins. This should be benchmarked to peers). And if the numbers then do not pan out along expected lines, the money should be clawed back.

Assumptions:

a. Royalty is calculated net of taxes to compute - royalty/dividend ratio and dividend + royalty/ share
b. Dividend amount includes dividend distribution tax
c. Dividend (including royalty) is calculated assuming same payout ratio and effective tax rates for FY08 and FY12
d. Margins are taken on net sales

Source:

Source of data is from company filings, market information.

[&] **Period:**
2012 - Includes YE Dec 2011, Mar 12, June 12
2011 - Includes YE Dec 2010, Mar 11, June 11
2009 - Includes YE Dec 2008, Mar 09, June 09
2008 - Includes YE Dec 2007, Mar 08, June 08

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