



CORPORATE GOVERNANCE DEBATE

ROYALTY PAYMENTS TO GROUP COMPANIES

On May 5, 2010, the Government of India amended the Foreign Exchange Management (Current Account Transactions) Rules, 2000, omitting the requirement for prior approval from Ministry of Commerce and Industry for royalty payments to technical collaborators exceeding 5% of domestic sales and 8% of export sales. On May 13, 2010, RBI correspondingly issued a notification permitting banks to release foreign exchange for making such royalty payments. Thus, all regulatory requirements that capped royalty payments to foreign collaborators have been completely removed.

In July 2010, Maruti Suzuki (India) Limited ("Maruti") disclosed that it had paid 5.1% of its sales for the quarter ended June 30, 2010 as royalty to its parent Suzuki Motor Corporation of Japan. Thus, while sales increased by 27% year-on-year for the quarter, it was accompanied by a 20% fall in net profit year-on-year. To put the quantum of royalty payments into perspective, they amounted to almost 64% of Maruti's pre-tax profit or 88% of its post-tax profit.

More than Maruti itself, it brings some corporate governance issues to the fore:

- (a) What is the fair quantum of royalty to a technical collaborator when the collaborator is a group company - both from the standpoint of the technical knowhow provided as well as sharing profits with minority shareholders?
- (b) Whether it is appropriate from a governance standpoint to inform minority investors about the quantum of royalty post facto?
- (c) Should royalty agreements with technical collaborators who are also group companies, be put to a shareholder vote, especially where the royalty payments are a substantial portion of a company's profits?

To answer these questions with benchmark data, we analyzed the royalty and R&D expense data of two kinds of companies that might be considered benchmarks: MNCs with India revenues of more than Rs.5,000 crore and listed auto companies in India with revenues of more than Rs.5,000 crore.

Selected Company Data on Group Royalty Payments and R&D Expenses

Company	Financial Year	Sales (Rs.crore)	Pre-tax-Profit (Rs.crore)	Net Profit (Rs.crore)	Group Royalty (Rs.crore)	R&D (Rs.crore)	Group Holding	Royalty		
								% of sales	% of PBT	% of PAT
ABB	2009	6,309.70	527.39	354.63	75.16	-	52%	1%	14%	21%
Bosch	2009	4,749.70	793.40	590.60	51.30	-	71%	1%	6%	9%
Hero Honda Motors	2009	12,319.12	1,781.46	1,281.76	324.01	32.10	26%	3%	18%	25%
Hindustan Unilever	2010	17,764.27	2,720.47	2,156.63	127.38	28.60	52%	1%	5%	6%
Ranbaxy Laboratories	2009	7,597.00	1,009.70	296.40	0.03	494.30	65%	0%	0%	0%
Siemens	2009	9,233.60	1,088.30	692.30	-	7.89	55%	0%	0%	0%
Tata Motors	2010	94,312.37	3,522.64	2,516.89	-	1,171.00	42%	0%	0%	0%
Mahindra & Mahindra	2010	31,568.54	4,029.96	2,891.12	-	275.72	28%	0%	0%	0%
Bajaj Auto	2010	11,543.00	2,310.90	1,596.90	-	134.70	50%	0%	0%	0%
Ashok Leyland	2010	7,244.71	544.77	423.67	-	148.53	45%	0%	0%	0%
Maruti Suzuki (India)	2009	20,557.90	1,705.40	1,231.70	677.70	91.00	54%	3%	40%	55%
	Q111	8,050.60	644.05	466.93	410.58			5%	64%	88%

(Source: Company Annual Reports)

InGovern Views on Royalty Payments

InGovern views on the above debate on Royalty payments are:

- (a) To establish the fair quantum of royalty is a tricky task, given the fact that royalty agreements are not identical in scope. However, from the limited data points in the below table, about 1% of net sales or 25% of net profits seems to be the upper limit. Again, this is subjective and depends on each company's strategy.



- (b) Regarding post facto disclosure, Maruti shareholders have voted against this by pushing the share price down sharply by 12% on the day after the Q1FY11 results. Irrespective of what is the cause, markets never like negative surprises, so it is not a good idea to make a post facto disclosure.
- (c) Of course, a best-practice would be to put to shareholder vote the Royalty Agreement, especially where the collaborator is a group company. This will address all corporate governance concerns – such as fairness of royalty amounts, ab-initio disclosures and transparency right up front. Thus, regardless of legal requirements, we would recommend that companies put any substantial related-party Royalty Agreements to shareholder vote.

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