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Royalty flows in Suzuki's blood

Suzuki needs to explain the basis of charging Maruti very high rates of royalty. Royalty payments aggregated 5.7% of net sales and 36% of profits before royalty in 2014-15. Over the past 15 years, royalty paid to Suzuki, has grown 6.6x to Rs.21,415 per car sold, while average sales realization per car has increased only 1.6x. While Suzuki's consolidated R&D spend per vehicle (including motorcycles) averaged 4% of sales, its royalty payments from Maruti are 6% of net sales.

Most multi-nationals charge their Indian companies royalty. This royalty is typically charged for either the brand and / or product technology. The basis for this charge is that the global brands have been developed outside India, as is the product research and technology. There is some merit to this argument, but the question is how much should be claimed.

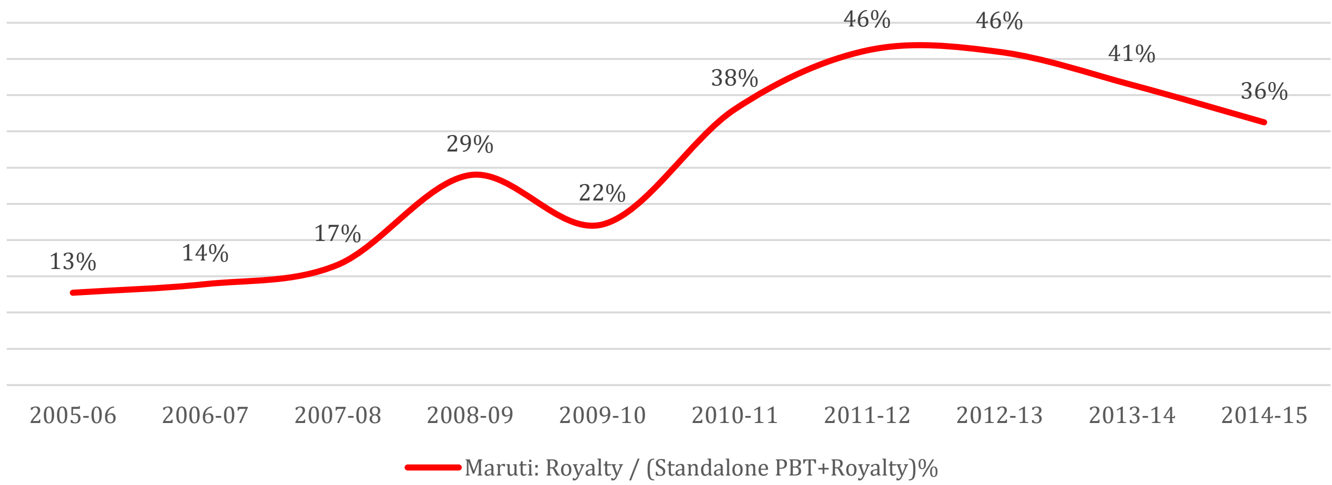
The Maruti-Suzuki royalty relationship

Maruti cars are for the most Suzuki's products that emanate from the research and development undertaken in Japan. Yet, Maruti has been a stronger brand in India than Suzuki. To the extent that Maruti uses Suzuki's technology, it must pay royalty. But how much is enough?

IiAS examines Maruti's royalty payouts in the context of revenues, margins, and research and development (R&D) spends, and concludes that Maruti's royalty payouts are extortive.

Maruti has been paying royalty to Suzuki for its car manufacturing technology since inception. Over the past five years (2010-11 to 2014-15), Maruti's aggregate payout towards royalty was Rs.118.7 bn while the 5-year profit before tax (PBT) aggregated Rs. 167.7 bn (Table 1). In 2014-15 alone, royalty expenses aggregated 36% of profit before tax and royalty[1] (Chart 1).

Chart 1: Over the past 10 years, royalty payments increased from 13% of pre-tax pre-royalty profits to almost 40%



Source: Company Annual Reports

[1] *Calculated as Royalty / (standalone PBT + Royalty)*

Maruti pays royalty in two parts:

- Running royalty: This is a recurring expenditure and is paid under several license agreements for technical know-how.
- Lumpsum royalty: This is incurred towards obtaining technical knowhow or assistance in manufacturing a new model. This amount is paid upfront and reported as an intangible asset in Maruti's financial statements. These intangible assets are depreciated over a 4-year period on a straight-line basis from the start of production of the relevant new model.

Box 1: Royalty payments do not usually require shareholder approval

Investors must engage with companies to understand the terms and conditions based on which royalty is being paid. Royalty payments, although these are with related parties, are not presented to shareholder for a vote because:

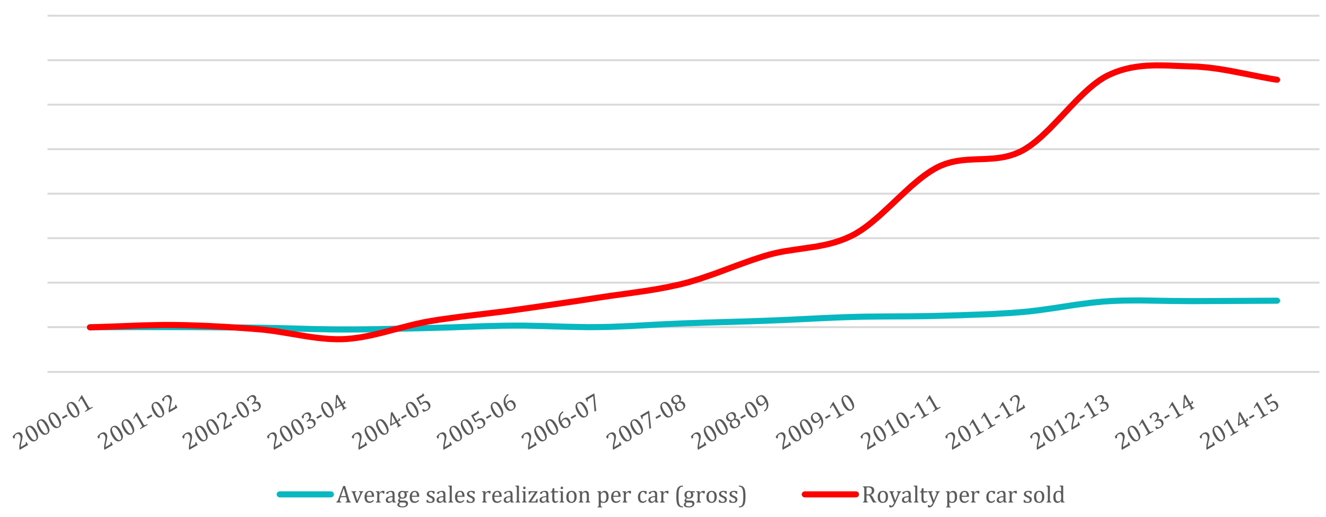
- Companies classify these as transactions in the ordinary course of business, and claim that these are being paid at arm's length pricing: under Companies Act 2013, such transactions do not need shareholder approval.
- Since the transaction value is rarely over 10% of revenues or networth, shareholder approval under SEBI's Listing Agreement is also not required.

Suzuki's R&D efforts do not appear to aid Maruti's margins or expansion

Maruti is India's largest car manufacturer. It has the largest product portfolio and the largest service network. Suzuki's already available fuel-efficient small car portfolio is the perfect fit for the Indian customers' demands. But more than this, Suzuki benefitted enormously from its partnership with the Government of India (GoI) at a time when India was fiercely regulated, and displacing a largely monopolistic market was not difficult. It was this partnership in its formative years that has given "Maruti" its edge.

The company's expansion of the product portfolio and its move towards higher-priced sedans has resulted in a very limited increase in per car realizations. Over the past 15 years, Maruti's gross sales realization has grown only 1.59x, which amounts to an annual growth rate of a little over 3%. Compared to this, royalty has grown 6.56x over the same 15-year period (Chart 2).

Chart 2: 15-year (rebased) growth of Maruti's royalty per car sold vis-à-vis gross sales realization

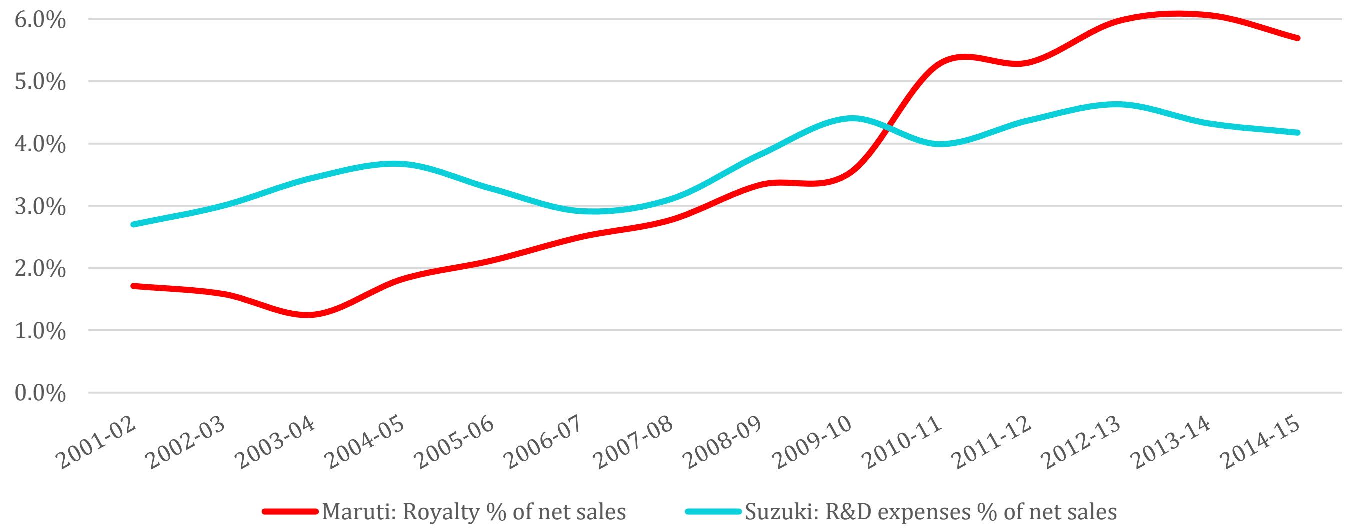


Source: Company Annual Reports

Maruti's EBITDA margins (after royalty payouts) at over 12% are almost twice that of Suzuki's sub-7% margins for the automobile segment (Table 2). Maruti's margins emanate from its own local efforts of cost control, value engineering, and indigenisation.

Over 15 years, royalty payouts from Maruti have grown from 2% to almost 6% of net sales. However, Suzuki's investments in R&D have not stepped up accordingly: in 2014-15, Suzuki's expenditure in R&D aggregated only about 4% of net sales (Chart 3).

Chart 3: Maruti's royalty has outpaced Suzuki's R&D expenses in the past five years



Source: Company Annual Reports

Maruti's own efforts hold the key

Over the past three years, Maruti has invested an average of over Rs.3000 per car (produced) in R&D efforts: capital expenditure aggregating Rs.10.14 bn and another Rs.8.14bn in revenue expenditure (Table 3). Maruti's R&D efforts have supported the launch of the new models and variants, new feature developments and fuel efficiency improvement efforts in the recent past (Table 4).

The Rohtak R&D facility (Suzuki Group's first R&D centre outside Japan) is expected to be fully functional by the end of the current fiscal. Among other facilities, the Rohtak R&D facility is expected to aid in testing and validating products to meet new regulations regarding safety and environment. If the incremental investment in R&D facilities is largely being made in India through Maruti, should shareholders expect a reduction in royalty payouts per car going forward?

Maruti shareholders must ask the fundamental question: what is the right amount of royalty that must be charged? Royalty is not Suzuki's indelible right – it must explain its coercive charges on Maruti's cash flows.

Table 1: Maruti's royalty expense over the past 15 years

Year	Cars sold (Domestic + Exports) Nos. A	Running Royalty Rs. Mn. B	Lumpsum Royalty Rs. Mn. C	Lumpsum Royalty Amortized Rs. Mn. D	Total Royalty expensed Rs. Mn. E=B+D	Royalty / car sold Rs. F=E/A
2000-01	350,814	1,052	-	93	1,145	3,263.8
2001-02	352,404	1,160	-	50	1,210	3,433.6
2002-03	362,426	1,129	-	-	1,129	3,115.1
2003-04	472,122	1,134	-	-	1,134	2,401.9
2004-05	536,301	1,986	-	-	1,986	3,703.1
2005-06	561,819	2,544	-	-	2,544	4,528.1
2006-07	674,924	3,673	-	-	3,673	5,442.1
2007-08	764,842	4,952	-	-	4,952	6,474.5
2008-09	792,167	6,791	-	-	6,791	8,572.7
2009-10	1,018,365	10,182	194	35	10,217	10,032.7
2010-11	1,271,005	18,925	454	156	19,081	15,012.5
2011-12	1,133,695	18,031	2,015	373	18,404	16,233.6
2012-13	1,171,434	24,538	629	901	25,439	21,716.1
2013-14	1,155,041	24,861	575	1,000	25,861	22,389.7
2014-15	1,292,415	26,574	2,104	1,103	27,677	21,414.9

Source: Company Annual Reports

Table 2: Maruti is more profitable that Suzuki's global automobile business

		2010-11	2011-12	2012-13	2013-14	2014-15
Suzuki Motor Company, Japan						
Automobiles sold	in thousands	2,641	2,560	2,661	2,711	2,867
Net sales: Automobile segment	$ Bn	27.36	26.88	24.43	25.41	22.48
EBITDA: Automobile segment	$ Bn	1.31	1.39	1.60	1.74	1.43
EBITDA%: Automobile segment	%	4.8%	5.2%	6.6%	6.9%	6.4%
Maruti Suzuki India Limited, India						
Cars sold (Domestic + Exports)	in thousands	1,271	1,134	1,171	1,155	1,292
Net sales (standalone)	Rs. Bn.	361.28	347.06	426.13	426.45	486.06
EBITDA (standalone)	Rs. Bn.	41.47	33.40	50.42	59.19	75.45
EBITDA %	%	11.5%	9.6%	11.8%	13.9%	15.5%

Source: Company Annual Reports

Table 3: Maruti's R&D spends have increased over the past five years

Year	Production Volumes Nos A	R&D Revenue expenses Rs. Mn. B	R&D Capex Rs. Mn. C	R&D Capex Amortization Rs. Mn. D	R&D per car produced Rs. E=(B+D)/A
2000-01	350,376	261			744.9
2001-02	358,108	299			834.9
2002-03	359,960	220			611.2
2003-04	472,908	282			596.3
2004-05	540,409	368			681.0
2005-06	572,127	396			692.2
2006-07	667,048	536			803.5
2007-08	777,017	379	259	24	518.1
2008-09	774,738	666	244	46	918.7
2009-10	1,027,879	1,110	623	102	1,179.5
2010-11	1,273,361	1,847	2,316	313	1,696.2
2011-12	1,134,607	2,226	1,491	448	2,357.2
2012-13	1,168,917	2,533	2,613	686	2,753.8
2013-14	1,153,645	2,265	4,311	1,078	2,897.7
2014-15	1,308,446	3,340	3,220	1,371	3,600.2

Note: R&D capex amortization has been assumed at 11-year straight line method. Maruti depreciates its plant and machinery on a straight line basis using an estimated life of 8-11 years.
Source: Company Annual Reports

Table 4: Benefits of Maruti's R&D efforts in the past three years

Year	Benefits of Maruti's R&D effort
2014-15	• Launch of new Alto K10 with new exterior and interior design, auto gear shift (AGS) technology and safety features like driver airbag, and front fog lamps. • Launch of Ciaz, a mid-size sedan with advanced features: this model was designed at Suzuki, Japan with active involvement of Maruti's R&D engineers. • Launched face lifted versions of Swift and Dzire with front fascia change and features like keyless push-start, reverse parking sensors, blue tooth audio, and electrically foldable outside rear view mirror. • Expansion of Maruti's portfolio of export models by developing special variants of Alto K10, Celerio, Ertiga and Ciaz for international markets. • Maruti achieved upto 15% increase in fuel efficiency during the year across all models. • Maruti saved Rs. 2.24 billion by localization and Rs. 2.47 billion from implementation of value analysis/value engineering proposals.
2013-14	• Celerio launch: Celerio was designed at Suzuki, Japan and Maruti's engineers participated in its development effort to improve Maruti's engineering capability. • Maruti introduced the auto gear shift (AGS) technology in passenger cars, which was first for any manufacturer in India. The AGS technology solution maintains the same fuel efficiency as manual transmission vehicle at a much lower cost than a contemporary automatic transmission. The technology was branded as `EZ Drive'. • Launch of Stingray with advanced features like projector headlamp, and reflector grill. • Launched several export variants of Ertiga, Alto, Swift, Ritz and Omni and expanding Maruti's export portfolio. • Maruti's engineers and managers have played active role in laying the road map of safety regulations, emission and fuel efficiency regulations in India and globally.

Year	Benefits of Maruti's R&D effort
	• 19 patent applications were filed by the Maruti's R&D team in 2013-14. • 12 industrial designs were granted to the Maruti's R&D team in 2013-14.
2012-13	• Alto 800: the first full body change was indigenously and entirely designed and developed by Maruti's engineers with the support from Suzuki, Japan. • Ertiga launched in April 2012 created an entirely new compact MPV segment due to its designing • Introduction of the refreshed Ritz, both with automatic and manual transmission features. • Introduction of Wagon R with new refined interiors and better fuel efficiency. • Introduction of the refreshed SX4 with touch screen audio and navigation features. • All models, except the Gypsy, were made on-board-diagnosis II compliant well before deadline. • 25 patent applications and 8 industrial designs were filed by Maruti's R&D team in 2012-13

Source: Company Annual Reports

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