International Related Party Transactions: The Royalty Syndrome

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A Related Party Transaction (RPT) means a transfer of resources, services or obligations between a reporting entity and its related party, regardless of whether a price is charged or not for the same. Related party relationships are a normal feature of commerce and business. **For example,** corporates frequently carry out parts of their activities through their subsidiaries, joint ventures and associates. In these circumstances, the related party has the ability to affect the financial and operating policies of the reporting entity through the presence of control, joint control or significant influence, which could also have an *adverse impact* on the operations, and consequently, the financials of the reporting entity. The impact could be highly adverse in the case of Indian subsidiaries of foreign MNCs. **Among others royalty payments (or general licence fees), which the Indian subsidiaries are made to pay to their foreign masters, are largely perceived to be excessive and unjustified.**

In this background, a detailed case study was conducted to examine the RPTs of **Nestle India Ltd.**, which is the Indian subsidiary of Switzerland based multinational food business conglomerate **Nestle SA Group**, as reported in the former's 2019 annual report and earlier reports. The case study examined data of each and every reported RPT of Nestle India for the year ended 31st December, 2019, and summary data for previous 9 years and was completed in March 2020. **This article seeks to share with the readers the findings of the study on perceived excessive royalty part of the RPTs.**

A. Relevant data from the case study is presented hereunder to facilitate discussion.

Exhibit 1: Nestle India Ltd.

Details of General Licence Fee (Royalty) Outflows over 10 Years Ending 31st December, 2019

											INR Millions (Rounded)
	2019	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**Total**
General licence fee (net of tax)	5,472	4,926	4,173	3,618	3,038	3,512	3,087	2,885	2,574	2,157	**35,442**
Withholding tax on general licence fee	547	493	417	362	304	351	309	289	258	334	**3,664**
Total fee	**6,019**	**5,419**	**4,590**	**3,980**	**3,342**	**3,863**	**3,396**	**3,174**	**2,832**	**2,491**	39,106
Y-to-Y growth in GLF%	*11.08*	*18.06*	*15.34*	*19.09*	*-13.5*	*13.76*	*7.02*	*12.04*	*13.69*	…..	
Sales	*1,22,953*	*1,12,162*	*1,01,351*	*94,096*	*81,233*	*98,063*	*90,619*	*83,023*	*74,908*	*62,547*	***9,20,955***
Total fee as %age to sales	4.90%	4.83%	4.53%	4.23%	4.11%	**3.94%**	**3.75%**	**3.82%**	**3.78%**	**3.98%**	**4.26%**

Exhibit 2: Nestle India Ltd.

Miscellaneous Financial Information over 10 Years Ending 31st December, 2019 **INR Millions**

	2019	**2018**	**2017**	**2016**	**2015**	**2014**	**2013**	**2012**	**2011**	**2010**	**Total**
Sales	1,22,953	1,12,162	1,01,351	94,096	81,233	98,063	90,619	83,023	74,908	62,547	**9,20,955**
Y-to-Y growth in sales**%**	9.62	10.67	7.71	15.84	-17.16	8.21%	9.15	10.83	19.76	…..	**….**
PBT	26,750	24,290	18,393	15,454	13,172	17,744	16,780	15,526	13,879	11,450	**1,73,438**
PBT to Sales**%**	21.76	21.66	18.15	16.42	16.21	18.09	18.52	18.7	18.53	18.31	**18.83**
Advertising & sales promotion (ASP)	7,853	7,294	5,060	4,996	5,252	4,455	3,955	3,559	3,276	3,026	**48,726**
ASP to Sales**%**	6.39	6.5	4.99	5.31	6.47	4.54	4.36	4.29	4.37	4.84	**5.29**
Capital Expenditure	1,522	1,628	1,959	1,133	1,493	4,044	3,282	9,744	15,552	4,459	**44,816**
Dividend paid:											
Usual Dividend per share (INR)	126	113	86	63	48.5	63	48.5	48.5	48.5	48.5	**693.5**
Special dividend per share (INR)	180	…	….	…..	….	…	….	…..	….	…..	180
Total dividend per share (INR)	306	113	86	63	48.5	63	48.5	48.5	48.5	48.5	**873.5**
No. of O/S shares	**9,64,15,716**										
Total Usual dividend (INR Million)	12,148	10,895	8,292	6,074	4,676	6,074	4,676	4,676	4,676	4,676	**66,863**
***Special** interim dividend (INR Million)*	17,355	…	….	…..	….	…	….	…..	….	…..	**17,355**
Total dividend (INR Million)	29,503	10,895	8,292	6,074	4,676	6,074	4,676	4,676	4,676	4,676	**84,218**
Dividend paid to holding company (INR Million)	18,518	6,838	5,204	3,812	2,935	3,812	2,935	2,935	2,935	2,935	**52,859**
Equity share capital (INR Million)	**964.2**										
Holding company's equity capital (INR Million)	**605.2**										
Note: Special dividend was paid out of past accumulated profits.											

B. **Exhibit 1** reveals that during 2019 Nestle India paid INR 5,472 Million towards General licence fees (net of withholding taxes) amounting to 4.50% of sales. Withholding tax of INR 547 Million on general licence fees was also paid amounting to 0.0045% of sales. Thus the total outgo of INR 6019 Million aggregating 4.90% towards royalty was though within the threshold limit of 5%, and *not material legally speaking*, it was still highly substantial being 1.45 times the earlier threshold limit of just 2%. Further, over the last 10 years Nestle SA got paid sums aggregating to INR 39106 Million by way of royalty from Nestle India.

C. Another revelation is that Nestle India has paid sums aggregating to INR 52859 Million as dividend to its foreign masters over the last 10 years on a meagre capital base of INR 605.20 Million subscribed to by them. It works out to a staggering 87.34 times pay back. (Add to this the dividend earned in earlier years and the pay back will magnify further). Coupled with royalty Nestle India has paid sums aggregating to INR 91965 Million (towards dividend and royalty) over the last 10 years resulting in to a 152 times pay out.

D. **Exhibit 1** further reveals that over the last 10 years (ending December 2019) Nestle India's GLF payments have increased from 3.98% of sales to 4.90%. It has paid sums aggregating to INR 39,106 Million as royalty over the last 10 years. Payment of such huge sums raises question-marks on their desirability in view of the following concerns:

1. **Computation base** of royalty charged is not disclosed by the company. Why should it not be paid on cost basis keeping in mind the *father-son relationship* between Nestle SA and Nestle India and de-linked from the sales?
2. In any case, increasing royalty payments year after year are supposed to reflect in increased profits as well. Therefore, as a more rational alternative, royalty should be *linked to PBT and not sales, if at all it to be linked*.
3. It could be noted that year after year growth in sales (**Exhibit 2**) has been far less than growth in **GLF (Exhibit 1). For example,** current year 2019 sales grew by just 9.62% whereas GLF grew by 11.08% and 2018 sales grew by 10.67% only while GLF grew by a huge 18.06%. It means there has been *inverse and adverse relationship between sales growth and GLF growth*. This is so because royalty is inflated not just by sales but by rising royalty rates as well. Sales therefore is not the right base for GLF calculation. The situation can be somewhat corrected by linking royalty rates with both positive as w*ell as negative growth rate in sales.*
4. GLF payment has gone up (**Exhibit 1**) regularly from 3.98% of sales in 2010 to 4.90% in 2019. PBT as %age of sales (**Exhibit 2**) has been static around 18.50% over the last 10 years, with even decline during 2016 and 2015 to 16.21%, except the year 2018 when it improved to 21.66% and remained static again during 2019. GLF payments therefore had no positive impact on PBT either.
5. One more observation here. Royalty payments (**Exhibit 1**) have been moving parallel to dividend distribution (**Exhibit 2**), except 2019 due to special dividend. It may be noted that in many years the royalty payment is even more than the dividend paid.
6. Apart from royalty, huge advertising expenses (**Exhibit 2**) are also being incurred by Nestle India year-after year. If we argue that royalty contributes to more profits, logically advertisement expenses should go down. Contrary to this assumption, advertising and sales promotion expenses have increased to 6.39% of sales in 2019 from 4.84% in 2010.
7. Materiality threshold limits indirectly indicate the desire of the regulators that RPT sunk outflows should not exceed those thresholds. This threshold for GLF was 2% of sales before June 2019. However, Nestle SA Switzerland seemed to be ignoring this signal year after year charging Nestle India around 5% in recent years which even in the year 2010 was 3.98%.
8. Excessive GLF payments to the controlling company means that they are eating in to the profits belonging to minority shareholders and thus transferring their share of dividend to the controlling company.
9. In addition to centralized R&D base, an R & D Centre has been opened in India also, though under the ownership of the holding company. Why should it not be under the ownership of Nestle India to reduce the burden of royalty payments?
10. And finally, in view of 87.34 times pay back on equity capital by way of dividend itself (on an average 8.73 times per year), is there still a case for saddling the Indian subsidiary by way of royalty and in any case excessive royalty?

E. It is amply clear that Nestle SA has been charging excessive royalty from Nestle India without any seemingly tangible contribution. Holding company and Subsidiary company Relationship is often referred to as *Father-Son Relationship*, very idea being that the holding company is supposed to nurture its subsidiary like a father nurtures his son selflessly. An example of this relationship being maintained in spirit is manifest in the '**Tata Brand Equity and Business Promotion (TBEBP)**' scheme agreed upon with its subsidiary companies, which has been revised voluntarily to put a cap on the royalty payments by them. Read the extracts from an article published in The Times of India on June 29, 2015:

Exhibit 3: Tata Brand Equity and Business Promotion (TBEBP) Scheme

THE TIMES OF INDIA

Tata Sons caps group companies' brand fee at Rs 75 crore.
TNN | Jun 29, 2015, 06.37 AM IS

MUMBAI: Tata Sons, owner of the Tata brand and promoter of Tata companies, has capped the royalty payment from group entities using the Tata name at *Rs 75 crore (INR 750 Million)*. The cap on maximum royalty amount is aimed at *reducing the burden on its large and profitable units and also freeing up cash for their growth*. The move by Cyrus Mistry-led holding company for India's largest conglomerate, with a brand value of $21 billion, **is in contrast with decisions by several MNCs to saddle their Indian arms with higher royalty payments.**

- Laid out in 1996, under an agreement titled **Tata Brand Equity and Business Promotion (TBEBP),** companies using the 'Tata' name have to directly shell out 0.25% of the annual revenue (operating) or 5% of the profit before tax, whichever is less. If companies incur losses, they do not pay any royalty. TBEBP has been modified to accommodate certain group companies that have, over the years, grown exponentially and were paying huge fees under the earlier system. For instance, software giant *Tata Consultancy Services, paid Rs 75 crore (INR 750 Million) in fiscal 2015 under the new system. If the old arrangement was in place, it would have had to cough up Rs 236 crore* (INR 2360 Million) towards brand subscription fee. *Tata Motors, which made a loss of Rs 4,739 crore (INR 47,390 Million), didn't pay anything in fiscal 2015.*
- "The largest amount that a company pays us now is Rs 75 crore. We have **put a cap on this voluntarily**," said a Tata Sons official.

Source: Tata Sons, TBEBP agreement, https://timesofindia.indiatimes.com/business/india-business/tata-sons-caps-group-companies-brand-fee-at-rs-75-crore/articleshowprint/47858586.cms

It is pertinent to note here that this brand usage charge *of just 0.25% of sales with a further cap at just INR 750 Million* as above **applies to Tata Sons' foreign subsidiaries as well. There is no discrimination between Indian subsidiaries and foreigners.** One can only hope that Nestle SA also gives similar treatment to its subsidiary companies like Nestle India through whom it has been having a relationship of more than 100 years with India. ***Interestingly, assuming Nestle India was a subsidiary of TATA Sons, it would have to pay towards royalty just INR 307.38 Million for the year 2019 as against INR 5472.00 Million paid to Nestle SA, being just 5.62% of Nestle SA royalty..***

F. The Case against Royalty

Is there a case still for paying royalty, as high as running parallel to already liberal dividend payouts? If royalty payment could be dispensed with, the 2019 EPS will rise from INR 204.28 to INR 250.24 registering a growth of 22.50%, with *corresponding positive impact on NPM, RONW, Net worth and share price, and thus on shareholder value.*

G. Impact on EPS if Nestle SA followed Tata Sons in GLF fees payments

Taking another view that royalty be also paid albeit on the lines of Tata Brand Equity and Business Promotion (TBEBP) scheme of Tata Sons, computations reveal that the 2019 EPS will still rise from INR 204.28 to INR 244.97 registering a growth of 19.92%, with *corresponding positive impact on NPM, RONW, Net worth and share price, and thus on shareholder value.*

The same story continues for subsequent years 2020 and 2021. And then Nestle India is not the only foreign MNC subsidiary. There are a large number of them. The Nestle case proves how Indian subsidiaries are subjected to unwarrantedly high royalty out flows towards their holding companies. It appears that as an ethical business policy the MNCs should be satisfied with dividends only which themselves are perceived to be excessively high when compared with domestic companies. Or else, regulatory authorities should intervene.

These are personal views of the author, without prejudice or bias towards any one