Global Reach

MNCs give higher returns than other companies. But investors must be aware about the risks associated with buying their shares | By **Shoaib Zaman**

Illustration: PRAGATI

In the one year between 1 February 2013 and 31 January 2014, the CNX Nifty rose 1.51%, while the CNX MNC index returned 5.58%. In the last six years, the CNX MNC has outperformed the CNX Nifty in four, and each time by more than four percentage points. Does this mean that stocks of multinational corporations, or MNCs, offer a degree of assurance in a market that is known to be anything but predictable?

WHY MNCs?

MNCs have a long history of making money for shareholders. Since a number of them have been in existence for long, they are easily identifiable—companies such as Nestle, Castrol and Gillette are household names.

In India, as in many other emerging markets, one of the biggest issues investors face is corporate governance and how much one can trust companies' financials. Here, MNCs have an advantage, as they are perceived to be more upright than most companies.

Vikas V Gupta, fund manager, Alpha L50 (India), Arthveda Fund Management, says, "The Indian market has two segments where corporate governance is a lesser problem, public sector companies or PSUs and MNCs."

Gupta says MNCs are usually headquartered in developed markets, which have stringent laws and capital market regulations. "Further, MNCs are rarely controlled by a single family," he says. "Also, their managements have more freedom. Executive control is also in the hands of independent boards."

MNCs compete in a global market that includes developed, emerging as well as frontier markets. They also have a wide range of products and brands. Their marketing, product development and brand creation expertise is unique because of these influences. Plus, their economies of scale can be matched by very few players.

Dipen Shah, head, Private Client Group Research, Kotak Securities, says, "MNCs have trusted brands, a wide range of products and huge distribution reach."

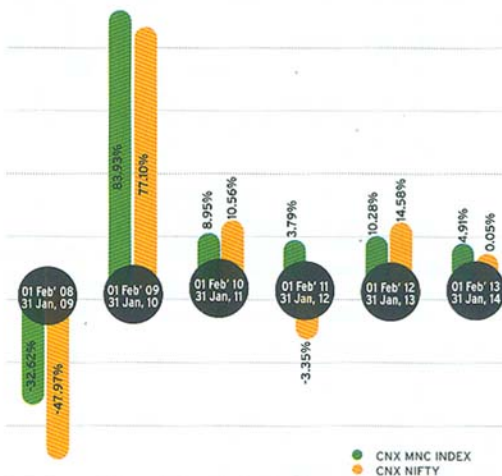
The general perception is that the sheer scale of operations will help these companies perform well even in tough times.

Several also generate huge cash, which attracts investors looking for a steady dividend income.

"MNCs have globally recognised brands, which are a pull factor for consumers. Management quality, too, is generally time-

MNCs Vs Market

The MNC index has beaten the Nifty in most years since 2008



CRITERIA USED FOR STOCK SELECTION

- The debt-equity ratio should show a declining trend or be less than two.
- Average three-year return-on-equity, or RoE, should be more than 20%; RoE in the latest financial year must be higher than 20%.
- Earnings per share, or EPS, in the last four quarters should be higher than that in the corresponding four quarters of the previous year.

Abbott India

1. The company has zero debt and doesn't pay any royalty
2. Three-year average RoE is 24%
3. Although foreign institutional investors, or FIIs, have negligible holding, domestic investors have 8% stake

Graph represents PE movement

tested," says Rakesh Tarway, vice president and head of Equity Strategy, Equity and Derivative Products, Motilal Oswal Securities.

CONCERNS WITH MNCS

One drawback of investing in MNCs' local arms is that the parent may try to take control of the business and delist it or transfer the subsidiary's major components such as research and development, manufacturing or brands to a 100% subsidiary while using the listed company for other aspect of the business. This may result in transfer of some core functions to the other subsidiary.

Among the well-known cases where MNCs have tried this include announcements by Honda Motor Company and Pfizer that they will set up 100% subsidiaries in the same line of business as the listed company.

"Even though MNCs are better at corporate governance, there have been several cases of shareholders being treated improperly," says Gupta of Arthveda. He says many investors think that MNCs have a huge product range, but don't realise that these brands are not owned by the listed domestic arm. At times MNCs even expand through a subsidiary other than the listed one.

There are royalty concerns too. "MNCs may try to siphon out profits through higher royalty charges or other fees that can be increased at the parent's whim," says Gupta. He says they may also try to delist by making a buyback offer in a bear market at a price that is significantly less than the local arm's intrinsic value.

Shah of Kotak says that although MNCs have presence across the globe, one should also keep in mind that they are exposed to headwinds in economies across the globe.

"So, compared to Indian companies, which are more or less immune to global factors, MNCs are more exposed. For instance, several MNCs in the financial space were hit by the sub-prime crisis in the US," says Shah.

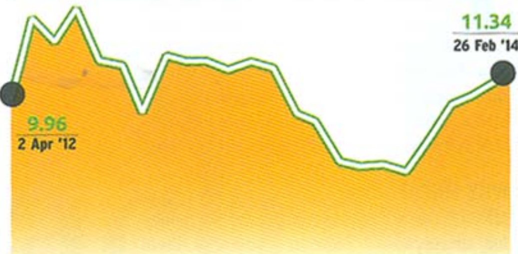
"Opaque transfer pricing and high royalty are some other risks associated with MNCs," says Tarway.

LOOK OUT FOR

"The same metrics should be used whether one is looking at an MNC or ahy other company," says Gupta.

One should prefer low-debt companies

Orient Refractories



1. The debt-equity ratio is just 0.05 times
2. The company paid a minuscule royalty of Rs 1.79 lakh on sales of Rs 359.85 crore in 2012-13.
3. The three-year average RoE is 43%
4. FIIs don't hold any share; domestic institutions hold a mere 0.04%.

Glaxosmithkline Consumer

1. The company is debt-free. Royalty, at 3.31% of net sales, was Rs 105.61 crore in 2012.
2. Three-year average RoE is 34%.
3. FIIs hold 11.68% in the company; domestic institutions own just 0.63%.

Bata India

1. The company is debt-free. Doesn't pay any royalty
2. Three-year average RoE is 35%
3. Foreign and domestic institutions hold 18.84% and 10.84%, respectively.

Graphs represent PE movement

with a large domestic investor base (this reduces the risk of delisting) that are trading below intrinsic values, says Gupta.

Also, one must look for consistency in financial ratios. This will help one catch number fudging and find out how robust the business is. "While investing in any MNC, the most important point is the commitment of the parent to the Indian subsidiary," says Shah. One way to judge this is the shareholding pattern and investment committed.

"Their brands, record in other markets and royalty and dividend policies are important," says Tarway. He says investors should focus on dividend payouts for debt-free companies that have historically reported good performance and maintain high return ratios.

ROYAL WORRY FOR ROYALTY

Royalty is a fee paid by a party to another for using its intellectual property. For instance, Maruti, founded as an Indian company, bought technology from Suzuki. For this, it pays Suzuki an annual fee.

A company could earlier remit royalty for technology up to 5% of domestic sales and 8% of exports. If there was no technology transfer, for using brand, etc, it could pay up to 1% of domestic sales and 2% of exports. Any extra payment required the approval of the department of industrial policy and promotion. The cap was withdrawn in 2009.

Many investors fear that MNCs are charging very high royalty from India subsidiaries and leaving nothing for investors in the domestic arm.

"High royalty payment is not an issue if the company is posting high profits even after paying the royalty. Royalty is a legitimate expense," says Gupta. If a company has a long record of high royalty payments and decent profit margins, there is no problem. "However, if the company has a history of randomly increasing royalty payments to the parent from time to time, it is a matter of concern".

Shah says the parent's commitment to the subsidiary should be closely watched. Any doubt on this count, he says, should be the single-biggest red flag.

Moreover, in recent times, several MNC arms have increased royalty payments to parents. "While the parent does bring in technology, excessive royalty is a negative for the Indian unit," says Shah. MT

P&G Hygiene & Health Care

1. P&G is a debt-free company.
2. The company paid royalty of Rs 79.8 crore on net sales of Rs 1,687 crore in one year to June 2013.
3. Three-year average RoE is 27%
4. FII stake is 2.4%; domestic institutions hold 12.17%.

Nestle India

1. The debt-equity ratio is just 0.58 times
2. The company doesn't pay any royalty
3. Three-year average RoE is 91%
4. FIIs hold 13.14%; domestic institutions own 5.19%.

Castrol India

1. The company has zero debt
2. Paid royalty of Rs 66 crore, 2.12% of net sales, in 2012
3. Three-year average RoE is 83%
4. FIIs have a large stake (8.97%); domestic institutions hold 5.53%.

Graphs represent PE movement