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The Agni Pariksha (Maruti - Suzuki)

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CASE SUMMARY: *Suzuki Motor Corporation of Japan will set up a plant in Gujarat to manufacture cars for its Indian unit, Maruti Suzuki India. The fully-owned subsidiary, Suzuki Motor Gujarat Pvt Ltd, will have a paid-up capital of ₹100 crore and be in place by April.*

Maruti Suzuki India's board has approved the proposal, which is expected to result in substantial financial benefits for the company and its minority shareholders. However, the stock market did not take kindly to the announcement and Maruti Suzuki's shares fell 8 per cent to close at Rs1,563.20 on the Bombay Stock Exchange.

Maruti Suzuki had proposed setting up a car plant in Gujarat, for which it acquired about 1,200 acres in Mehsana district. The company had also signed an agreement with the State Government to set up a plant with an annual capacity of 250,000 units with an initial investment of about Rs4,000crore.

"This (Suzuki Motor Gujarat – SMGPL) will not be a public listed company. It will only be a manufacturing entity. All the marketing and expansion of the dealer network will be taken care of by MSIL (Maruti Suzuki) and, in return, all three entities — Suzuki Motor Corp, MSIL and SMGPL — will share the profits," declared Osamu Suzuki, Chairman, Suzuki Motor corporation Japan.

The Gujarat plant will start operations from 2017 and roll out vehicles from early 2018, the company said. The cost of the new plant is estimated at Rs4,000crore in the first phase (till 2017), and this expenditure will now be incurred by Suzuki Motor. However, ownership of the land will remain with Maruti, which will, in turn, lease it out to Suzuki Motor.

The Japanese parent said it would also continue to fully support Maruti's existing plants in Gurgaon and Manesar, Haryana. In addition, the upcoming research and development centre in Rohtak, also in Haryana, will be under Maruti. The Suzuki subsidiary would not sell vehicles to anybody else, said RC Bhargava, Chairman, MarutiSuzuki.Thecompany would benefit because the vehicles would be sold without any return on capital employed, Bhargava said, adding that Maruti would avoid all risks inherent to any investment.

Higher localisation, cost reduction drive Maruti Suzuki

"Higher localisation, favourable foreign exchange and a cost reduction initiative by the company contributed significantly to the net profit," the carmaker said. However, net sales dropped 3 per cent to Rs10,619crore from Rs10,956 crore. Vehicle sales during the quarter also dropped 4.4 per cent to 2.88 lakh units (3.01 lakh units) and remained under stress during the period, in both domestic and export markets.According to analysts, the company reported stronger-than-expected results. "While the top line was broadly in line with our estimates, bottom line at Rs681 crore was higher than our estimates of Rs620 crore due to better-than-expected EBITDA margins at 12.4 per cent," said Yaresh Kothari, Research Analyst at Angel Broking.

Why investors shunned Maruti stock??

Despite a 36 per cent growth in net profit in the December 2013 quarter over the corresponding period last year, investor concerns on Maruti Suzuki India's plans for its Gujarat plant saw the company's stock lose 8 per cent after the announcement of the investment and operational details for their operations in Gujarat.

Earlier, the company had said a wholly-owned subsidiary of Japan's Suzuki Motor Corp would set up the proposed plant in Gujarat that would solely make vehicles for the Indian carmaker.

Maruti has also indicated that the price at which it will acquire cars from the Suzuki subsidiary will cover the direct cost of production. But since the proposed company will be an unlisted entity, one may never get to know the actual cost of production or the cost efficiencies of such an entity.

Secondly, Maruti will end up making only selling/distribution margins on these vehicles.

Since Maruti's capital invested for the Gujarat plant would only be the cost of the land it acquired, it expects return on capital to be much higher than the 17 per cent it earns now.

But once the Gujarat capacity comes on stream, the utilization ratio between its existing plants and the Gujarat facility would depend on its product plan, and market demand for different cars. This way, the company could end up with less than optimal utilization of capacity at each of its plants.

Third, the resulting jump in cash reserves in future years as a result of this plan, may not lead to investors getting handsome dividends. The company, which currently has cash reserves of about Rs7,500crore, is looking to invest more in research and development and building its marketing network. With the Gujarat plant originally envisaged for exports, Suzuki may also make India its export hub through this move. Cash reserves could be used for furthering the company's international investments

What Suzuki's Gujarat plant means for Maruti ?

"Maruti's decision to give the Gujarat plant to Suzuki may not be the proverbial win-win amid concerns about costly imports and pricing".AfterMaruti Suzuki announced that the proposed factory in Gujaratwill be owned not by it (as was originally planned) but by a fully-owned subsidiary of Suzuki Motor Corporation, the company's stock fell over 8 per cent. It did not mean much for the market that the company had announced a healthy 36 per cent growth in profit for the quarter ended December 2013. Analysts and brokers hammered the share because the move was perceived to harm the interests of the small shareholders and raised serious corporate governance issues.

Yet, just a day later and after a long and heated analyst call with the Maruti Suzuki management, the market changed its mind. The Maruti Suzuki share recovered most of the previous day's loss and closed 7.11 per cent up,the stock was an "outperformer" and "the actual impact of the deal will be known only in 2017-18 when the plant starts commercial production".

Cause of Concern?Should minority shareholders worry or not?

Many experts feel Suzuki is looking to exercise stricter control over its core business of making cars, and that may have prompted it to house the Gujarat factory in the new fully-owned subsidiary, Suzuki Motor Gujarat. (Suzuki owns 56.2 per cent of Maruti Suzuki.) This way, it will have greater control over product development.

Under the new arrangement, the new factory will produce cars which will be sold by Maruti Suzuki. The obvious question is what is the price at which Suzuki Motor Gujarat will sell to Maruti Suzuki? Maruti Suzuki has made it clear that the new company will sell the cars at cost price and not at a profit; so Suzuki will not make any return on its investment. The price will be determined on an "arm's length" basis. And the components will be sourced by Maruti Suzuki.

So, there is no way profits will get transferred from widely-owned Maruti Suzuki to closely-held Suzuki Motor Gujarat. However, there is nothing to stop the new company in the future - when it produces new models - from selling at a profit. Suzuki is going down the same route as many other multinational corporations in India, parking their most profitable business in a 100 per cent subsidiary, with the listed one either housing the less profitable business or operating just as a marketing arm.

Maruti Suzuki Chairman RC Bhargava says there is another reason why the new arrangement is good for the company's shareholders: its cash reserves of over Rs 7,500 crore fetch 8-9 per cent return as interest; this income would have come down if the Gujarat factory was funded out ofthe reserve. On the other hand, Suzuki, which earns less than 1 per cent on its cash reserves of Rs25,000crore in Japan, will enhance its returns.

Costly imports:

Yet, it might not be so simple. Experts say it won't be easy for the new subsidiary to justify the price of imported components it will buy from Suzuki because it intends to sell the cars to Maruti Suzuki at cost price. "This is not the case when the components are imported by Maruti Suzuki," says a transfer pricing expert. "It will be difficult for the subsidiary to justify the price of imported components unless the components are bought by Maruti Suzuki and then given to the subsidiary." Bhargava says the problem is not unique to the new subsidiary and such transfer-pricing questions are asked even now to Maruti Suzuki when it imports components because these are related-party transactions.

Tax experts say that under the domestic transfer pricing rules, there is no problem in the deal as the only thing which is scrutinized is expenditure and not income.As the new subsidiary will sell the cars at cost price and the profit margin will be booked by Maruti Suzuki on which it will pay taxes, there is no loss of revenue for the government. However over a period, income may also be included in the domestic transfer pricing rules. In that case the Gujarat subsidiary will face serious scrutiny as it has to justify why it is not making profits and at what price would it sell the same cars to third parties.?

Another issue is where will the new models be made? Will they be manufactured now in Gujarat, which means Maruti Suzuki - as well as its shareholders - will lose control over its growth plans? There are some other key issues., if the market drops, who will curtail production?: Maruti Suzuki or the 100 per cent subsidiary? Obviously, the decision in such a scenario will be taken not by Maruti Suzuki but by Suzuki. This is yet another decision that is set to slip out of the hands of the Maruti Suzuki shareholders.

Also, the land in Gujarat is on the books of Maruti Suzuki. This poses another question: When it leases the land to Suzuki Gujarat Motor, the rental will be built into the cost of the vehicle or will it be reimbursed toMaruti Suzuki separately? "If so, Suzuki will have free access to land that is partly owned by the 44 per cent non-promoter shareholders of Maruti Suzuki. Maruti Suzuki says that the lease rentals will not be as high that will increase the cost of the car, something it can ill-afford in an extremely competitive market

Also the question remains whether the cost of production would be cheaper in the 100 per cent subsidiary.? After all, it will have its own legal and human resource team and cannot use the infrastructure of Maruti Suzuki. This will only raise the cost.Maruti Suzuki says it will offer its employees the option to shift to Gujarat.

The labour link

Industry watchers say the move may have also been prompted by Suzuki Chairman Osamu Suzuki's growing concern with labor problems in the Manesar-Gurgaon region, where Maruti Suzuki's two factories are located. Frequent and violent strikes have caused the company significant loss of production in the recent past. "Inculcating the Japanese method of labor management on Manesar has been a disaster. So it is quite tenable that Suzuki wanted Gujarat to have nothing to do with the existing unions and it prefers to deal with the unions directly rather than through the Indian company.

The new deal has caused observers to debate the real cause of the move. "The problem is that whenever you have such a structure there is always the suspicion that the price mechanism is not transparent, especially when you know that Suzuki has tried to get greater control and extract more cash for its balance sheet in Japan," says the former executive of Maruti.

In 2004, Suzuki announced a 70/30 venture with Maruti Suzuki to make cars at Manesar. The deal created a furore, and the government threatened to stop investments by the company. Suzuki relented and the structure was overturned. After legal advice, it was found more prudent to merge it into Maruti Suzuki to avoid questions of transparency. However, it was able to create a 70/30 partnership for powertrains which was recently merged into Maruti Suzuki.

Suzuki has also been receiving huge amounts as royalty from Maruti Suzuki, which goes to shore up its profit in Japan. Thus, amongst all the companies listed on the Indian stock exchanges, none pays more royalty than Maruti Suzuki. The royalty payment to Suzuki has jumped nearly fivefold from Rs 493.1 crore in 2007-8 to Rs 2,450 crore in 2012-13. Royalty payment accounts for 5.8 per cent of Maruti Suzuki's net sales in 2012-13, up from a mere 2.8 per cent in 2007-8. More strikingly, it constitutes a staggering 47 per cent of Suzuki's profit after tax, say analysts. The latest m

The basic brunt of the unhappiness about Suzuki's plan is that it will allow the Japanese company to divert its India profits from a company it only partly owns to one it wholly owns, which it can then repatriate home.(TOI 24-02-2014)

At least seven fund houses have raised a red flag over Suzuki's plan to set up a manufacturing facility in Gujarat and asked for a "rethink", arguing that the move is "neither fair nor” in the interest of its 56%-owned Indian arm, Maruti Suzuki, and its minority shareholders.

The shareholders in MarutiSuzuki, have also complained about royalty payments by the country's largest carmaker to its Japanese parent. "Complete clarity and transparency on these issues is needed so that further damage to minority shareholders is avoided.MSIL should do everything possible to ensure that this trust is restored and maintained for ever," the fund houses said in a joint letter to the Maruti Suzuki chairman Mr RC. Bhargava.

On Jan 28 2014, the company's board had announced a decision to let Suzuki Motor Corporation set up a 100% subsidiary in Gujarat. Maruti Suzuki will source products from this facility, it had said.The decision was thumbed down by investors, with the stock falling 8% (although it has recovered since).

The basic brunt of the unhappiness about Suzuki's plan is that it will allow the Japanese company to divert its India profits from a company it only partly owns to one it wholly owns, which it can then repatriate home.It was Maruti Suzuki which was originally supposed to set up the plant.

Discussion Questions:

1. What in your opinion are the short term and long term issues of this Case??
2. What according to you is the long term strategy of Suzuki Motors in separating operational controls from Maruti Suzuki to Suzuki Motors in the Gujarat plant?
3. What are the consequences or fallout of this proposal on the IR situations at Manesar& Gurgaon plants –Incase of transfer of Employees to the new plant and the reduced stake in the Gujarat Plant might affect prospects of wage revisions negotiations- and productivity concerns?
4. Do you think there is a hidden agenda of the parties to the deal rather than simple calculations of fresh investment, and transfer pricing etc??

Authors Comments:

The above Case Study is one from a series of Case Studies developed by the Author.

The case studies developed by **the same author** are titled as

1. **‘Complicating Commonsense**”- Case Study Developed in 2011
2. ‘**Maruti’s Lanka**” - Case Study Developed in 2012.
3. ‘**Maruti’sSanjeevani’**- Case Study Developed in 2013
4. ‘**The Agni Pariksha’ -** Case Study developed in 2014

All the above Case Studies were entered in to ASM Group of Institutes MINDSCAPE Case Study Resolutions presentation Competitions for Corporates an event which is center staged by the author(Who is also a Senior Faculty at ASM Group of InstitutesPune) each year since 2004-05 as an Annual Mega event of the group. The Broader process of the competition is that the ASM Group (Its Faculty) offers Such Case Studies to Industry teams to study the cases and offer resolutions to the major issues through ‘Mindscape’ Competitions organised by ASM Group of Institutes each year at its campus in Pune..Major Industries like Tata Motors Ltd, Mahindra & Mahindra Limited, Siemens Ltd,Thermax ltd, Bajaj Auto ltd, Whirpool of India are regular participants in the ASM’s Mindscape Case Study Competitions for Corporates.

CASE TEACHING NOTES

About the Title: “THE AGNI PARIKSHA”

The Case study titled Agni Pariksha tries to draw a similybetween the mythological story of Ramayana.

After 14 years of exile and the tormenting situations faced by SITA under captivity of the wicked king Ravana, is made to undergo the separation from RAMA for whom she had sacrificed all her lively pleasures of being the Queen of Ayodhya in order to prove her Modesty & Sanctity on her release and return to Ayodhya after all the ordeals faced during the exile & captivity.

The story and the back ground of Maruti Suzuki Ltd as at present cross roads in respect of its proposed business model of the Gujarat Plant (Being forced to prove that it can manage its efficiency and stake holder satisfaction in spite of operating as a mere distributors/Traders in Passenger cars acquired on transfer price basis) completely owned by SUZUKI its Life Time Partner in Indian Operations since beginning ,is akin to SITA's parody ,& malady of going through the Agnipariksha.in Ramayana.

Utility of the case study:

1. The Case Study is very well suited for the students of Management Studies in understanding the Strategic Intents of a New project proposal between two partners of a business unit which has been a market leader in India over decades
2. The Case Study also helps clarifying the underlying principles of long range strategic planning for businesses in the emerging markets such as India.
3. Stake Holder interest optimization is one of the binding principles and strategic objectives of major organizations especially MNCs for long term survival and growth strategies.
4. Business Risk Analysis on proposals which do not have overwhelming support from its investors is yet another issue which can be deliberated through the case study
5. Issues which are and have been major irritants such as HR & IR need to be analysed from long term business perspectives. The Case throws light on the potential problems for the proposed project involving transfer of employees and fast changing employee engagement and relation issues in the times to come.

The CASE Teaching Methodology:

1. The Case needs to be used for teaching subjects in Business Management course of studies by the Instructor having prepared adequately the topics in strategic Management, through Organisational Vision Mission and Objective
2. The Students need to acquaint themselves with project Management principles and Stake holder roles in new projects
3. The Students may be formed in to heterogeneous groups-Students from different specializations such as HR, Marketing, Finance & Operations-Project Managementcould form a comprehensive team work for data collection and analysis of the case contents. Each team may be asked to present their observations analysis and resolutions on the format of role play by individual team members which would definitely offer clarity of concepts in Business Management.
4. The Instructor is also recommended to use other case studies as mentioned by the author (Other Case Studies refereed above can be offered on specific requests from the Institutions) to comprehensively make the students to understand the analogy of the Tilte and flow of contents in this case study and help developing a overall view of major business issues which need to be addressed by the Managers of Business setups.
5. The Instructor should ask for feed back from the students after leading the case study as in point 4 above to make sure that the concepts are clearly understood and if required could be referred to segmental aspects of the case study(HR, Marketing & Strategic issues separately) by individual explanations.
6. For specific requirements on Case Study development, Analysis and resolutions the instructor is advised to refer the Book titled 'Case Studies In Management' authored by Prof J.A.Kulkarni and published by Pearson Education in 2011.