Recently, while working on the Indian arm of a global engine manufacturing company (hereinafter referred to as SIL), we found some potential Corporate Governance issues mainly wrt the Capital allocation of the Company which minority shareholders may want to be aware of.

In this piece, we summarise some ofthe issues we found pertinent.

1) Substantial Divergence in performance of listed and unlisted entities.

SIL has many other group companies operating in India. The largest one is STIL – A wholly owned subsidiary of the global parent. Over the last decade, the parent has been shifting manufacturing operations to low cost countries like China and India. A lot of export business was supposed to come to India under this organisational rejig, which was expected to come to SIL, being the group's flagship company in India.

However, as evidenced from the data below, STIL has significantly outgrown SIL.

Revenue	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	CAGR
STIL	6,524	8,684	8,868	10,378	14,234	15,952	19,338	33,384	26%
Growth		33%	2%	17%	37%	12%	21%	73%	
SIL	39,454	40,522	45,090	38,991	43,211	51,308	49,876	49,816	3%
Growth		3%	11%	-14%	11%	19%	-3%	0%	

Similarly, analysing the export revenues of SIL and STIL, we can see that STIL has substantially outgrown SIL during this manufacturing shift to India.

Exports	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	CAGR
STIL	6,973	10,205	10,998	13,065	17,887	27%
SIL	12,193	17,268	16,847	15,222	14,448	4%

It is important to note that there is no stated bifurcation between the operations of these entities w.r.t their product lines. These seem to be assigned to the Companies on a somewhat ad hoc basis.
Comparing operating margins of the two entities also show that on average, STIL has been more profitable than SIL.

OPM	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18	Average
STIL	24%	18%	21%	20%	17%	17%	17%	16%	19%
SIL	19%	17%	18%	18%	16%	17%	14%	13%	16%

2) Discrepancy in allocation of business lines:

As seen from table 1 above, STIL's revenues have grown by 73% in 2018 compared to a small de-growth in SIL. This growth is mainly due to the Emissions Services business wherein they have provided after treatment services post the introductionof products for BS IV vehicles.

This growth in 2018 has mainly emanated from the domestic market.

It is interesting to note that SIL's previous annual reports have mentioned these 'after-treatment' technologies as products wherein they have been innovating to meet environmental standards. They have also mentioned the fact that the Company exhibited these products at industry exhibitions.
However, as per the 2018 Annual report of STIL, it seems that this business has been shifted to their domain.

3) Investment in R&D Center:

SIL has invested a fairly significant amount of money in developing a new tech center.

Particulars	2017	2018	2019
Tech Center			
Amount invested	2,706	4,756	264
Total	**2,706**	**7,462**	**7,726**
as a % of total gross block	12%	27%	27%
Investment as a % of OCF	32%	65%	4%
Rent income derived	153	272	561
Direct Exp	9	22	74
Profit	**144**	**250**	**486**
Yield	5%	5%	6%

This tech center is for the use of both SIL and the parent company. The Company had previously claimed that of the total capex of Rs 10,000 Mn of which 5000Mn would be borne by SIL. However, as seen, the actual investment was upwards of 7,700Mn.

As per the management of SIL, 70% of the R&D activities conducted here would relate to the parent company and the balance would be forSIL.

However, SIL's R&D expenses have not shown much change since this has come into use.

INR Mn	2012	2013	2014	2015	2016	2017	2018	2019
R&D Expenses	383	396	422	164	251	307	289	333
as a % of revenue	0.9%	0.9%	1.1%	0.4%	0.5%	0.6%	0.6%	0.6%

The Company has given this center on rent to various promoter entities and is earning a post-tax yield of around 5-6% before indirect expenses.

Incurring expenditure to the tune of 27% of total historical gross block for a tech center for related parties where the post-tax yield is 5-6% seemssuboptimalin terms of capital allocation.

4) Management Remuneration:

The top management of SIL are given ESOP's in the global parent entity and not in SIL. This may be detrimental to the interests of SIL shareholders as the focus of the managementmay be diverted towards the performance of the group and not SIL.

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