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Listing of L&T's subsidiaries: Management creates its own 'options'

L&T's executive directors have been opportunistic – they have generously issued themselves stock options at face value from subsidiaries before their IPO's. The manner and timing of these issuances raise questions on L&T's governance practices, and the checks and balances the company has in place.

As part of its long term strategy to unlock value, Larsen & Toubro Limited (L&T) decided to list two of its 121 subsidiaries in 2016 – Larsen & Toubro Infotech Limited (Infotech) and L&T Technology Services Limited (TechServices). As a conglomerate with several businesses, L&T's decision to list these businesses as they reach critical mass is good for its shareholders. But, L&T's management has also made the most of the opportunity – through the issuance of stock options.

Table 1: Stock options issued by Infotech between the filing of the DRHP and the RHP

	No. of options granted		Exercise price Rs.	Market price Rs.	Notional gain Rs. mn.
	Prior to DRHP (Apr-16)	Prior to the RHP (Jun-16)			
Sanjay Jalona	-	326,000	1.0	637.8	207.58
A M Naik ^[1]	1,800,000	300,000	1.0	637.8	1,337.18
S N Subrahmanyam	-	200,000	1.0	637.8	127.35
Aftab Ullah	-	122,000	1.0	637.8	77.68
R Shankar Raman	-	100,000	1.0	637.8	63.68
Ashok Kumar Sonthalia	-	50,000	1.0	637.8	31.84
Others	-	2,068,900	1.0	637.8	1,317.37
Total	1,800,000	3,166,900			3,162.67

Fair value of stock options: Rs. 387; Market price = Closing price on 21-Sep-2016; Vesting period = 5 years

Notional gain = Total no. of options granted x (Market price – Exercise price); the gains will occur over the vesting period

[1] The notional gain for AM Naik mentioned in the above table is the result of accumulation of stock options granted from 2002 till the time of the RHP. Between 2002 and 2011, AM Naik was granted 1.8 mn stock options at face value under an earlier ESOP 2000 scheme. The management has clarified that exercise date for these options was fixed starting from 2015, since the IPO was planned around this time. Out of this pool, he has exercised 871,875 options and the remaining 928,125 options were outstanding on the date of Infotech's RHP. Under ESOP 2015 Scheme, he was granted an additional 0.3 mn stock options at face value between the filing of the DRHP and the RHP.

Table 2: Stock options issued by TechServices between the filing of the DRHP and the RHP

	No. of options granted		Exercise price Rs.	IPO price Rs.	Notional gain Rs. mn.
	Prior to DRHP (Jul-16)	At the time of RHP (Aug-16)			
A M Naik	-	1,300,000	2.0	860.0	1,115.40
S N Subrahmanyam	-	200,000	2.0	860.0	171.60
Dr. Keshab Panda	-	300,000	2.0	860.0	257.40
Amit Chadha	-	200,000	2.0	860.0	171.60
Kumar Prabhas	-	150,000	2.0	860.0	128.70
P Ramakrishnan	-	50,000	2.0	860.0	42.90
Others	-	1,945,000	2.0	860.0	1,668.81
Total	-	4,145,000			3,556.41

Fair value of stock options: Not disclosed; IPO Price refers to the Upper Band of the IPO; Vesting period = 5 years

Notional gain = No. of options x (IPO price – Exercise price); the gains will occur over the vesting period

liAS believes that stock options serve as a good measure for long-term incentives. By stipulating conditions of grant, vesting and exercise, stock options can help link pay with price performance and therefore, align management and shareholder interests. Having said so, there are five issues we would like to focus on with regard to these grants:

Responsibilities as part of the holdco board

Three of L&T's board members (A M Naik, S N Subrahmanyam, and R Shankar Raman) have received stock options from Infotech and / or TechServices. Both these companies were, and continue to remain, part of the L&T group. Therefore, as board members of L&T, they are already responsible for the growth of these businesses – do they need to be rewarded separately just because these businesses are getting listed? We believe not – especially since all three executives draw remuneration from L&T, which we believe, is commensurate with the size and performance of the consolidated entity.

Remuneration committee composition

The Nomination and Remuneration Committees of both Infotech and TechServices include members of the L&T board – those that have rewarded themselves.

Table 3: Composition of Nomination and Remuneration Committees of both companies

	Infotech	TechServices
Chairperson	Samir Desai, Independent Director	Samir Desai, Independent Director
Member 1	A M Naik, Chairperson - L&T	A M Naik, Chairperson - L&T
Member 2	M M Chitale, Non-Executive Director ^[1]	Arjun Gupta, Independent Director
Member 3	S N Subrahmanyam, DMD - L&T	-

^[1] M M Chitale has been on L&T's board for 12 years. While the company continues to classify him as an Independent Director, liAS believes he is non-independent given his long association with the L&T group.

Generous dole-outs

liAS looks at issuance of stock options at deep discounts as deferred compensation – in both these cases though, the rewards have been generous. In the case of Infotech, 35% of the ESOPs granted have been to the board, and 19% of the total pool has been granted to the non-executive directors belonging to the L&T board. In TechServices case, 53% of the total pool has been granted to its board, and 36% of the total pool has been granted to L&T's board members.

Further, take the case of Infotech – the IPO price was Rs.710 and it closed on 21 September 2016 at Rs. 637.75. Investors in the IPO are currently losing money, while Infotech board's options, including those granted to L&T's executive directors, are well in-the-money.

Timing

The timing of the TechServices grant should also raise eyebrows. These stock options were issued between the filing of the draft red herring

prospectus (DRHP) and the red herring prospectus (RHP) ¹. Between the DRHP and the RHP, companies will have estimated the market appetite for the equity as well as arrived at a broad understanding of the price range at which the book-building process will close. Issuing stock options this close to listing at face value is assured money, irrespective of what the vesting and exercise periods are.

Disclosures

The disclosures on stock options are poor. Until the RHPs were filed, there were no available disclosures on the stock options being granted to L&T's board members from subsidiaries (Related Research: [Unlisted Subsidiaries – The New Cloaking Device](#))². How do shareholders then vote on overall compensation of L&T's executive directors, if material components of the remuneration structure are not being disclosed?

L&T forms part of the major indices and has garnered respect for being one of India's largest professionally managed conglomerates. However, this episode shows that L&T's executive directors behaved opportunistically. It raises questions on the company's governance quality and the checks and balances it has in place.

Independent of the imminent change of guard, L&T needs a stronger (and not larger) board that can stand up to the company's history and provide the required push-back to its senior management. The board must uphold the value system³ that the company has been built on.

¹ TechServices DRHP disclosed that it proposed to grant 6 mn options, but no details were provided. Of the proposed 6mn options, it granted 4.1 mn options (Table 2) before the RHP was filed. Of the 4.1 mn options, TechServices' board members were granted 53% of the total pool.

² L&T's management has confirmed that L&T's executive directors have received stock options from other listed subsidiaries in the past.

³ 'I want to leave behind a strong L&T that exceeds targets with value systems intact.' AM Naik to Economic Times [Read interview to Economic Time 22 September 2016.](#)

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