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SEBI's denial of L&T's buyback rekindles an old debate

SEBI's rejection of Larsen & Toubro Limited's (L&T) buyback raises questions on whether financial metrics should be considered at a consolidated level or at a standalone level. This refusal brings to the forefront the concern that much gets hidden in subsidiaries.

SEBI's rejection of L&T's buyback on account of the fact that consolidated debt-equity is a breach of its regulatory threshold of 2:1 post-buyback is possibly the first time that the regulator has raised the question of consolidated financial metrics vs. standalone financial metrics. Perhaps a lesson from the recent meltdown in the IL&FS group is playing on SEBI's mind. Even so, we argue that while L&T is not incorrect its stance, the regulator too has a point of view that should not be ignored.

Most of the push-back to SEBI's response comes from the fact that L&T's consolidated debt includes the debt of its financial services vertical – L&T Finance Holdings Limited (LTFHL; an NBFC-CIC) and L&T Finance Limited (the operating company). While a requirement of a debt-equity of 2:1 is text-book prudence for manufacturing companies, it is not so for companies in the financial services space. NBFCs, given the nature of their business, operate at a higher debt-equity: an NBFC with a debt-equity of 5x isn't unusual

The argument for a carve out of the NBFC is arguably weak because of L&T's implicit support to the credit profile of its subsidiaries, which includes the financial services business. L&T Finance Holdings Limited's ICRA AAA/Stable ratings "*draw significant strength from LTFHL's parentage, with Larsen & Toubro Ltd. (L&T, rated [ICRA]AAA/Stable) holding 64.01% (as on June 30, 2018) equity in the company, and LTFH group's increased strategic importance to the parent with financial services being a focus area for the L&T group and LTFHL being the holding company for L&T Group's financial services business.*" At best one can argue that the 2:1 debt-equity threshold is harsh because L&T has an NBFC in the group – but that argument is never-ending (it could then lead to companies asking for industry-specific debt-equity levels, and so on and so forth): the 2:1 debt-equity requirement must be looked at as a guidance to companies that they should not be considering buybacks if they have large debt on their books.

Large companies have complex structures. There are companies in the NIFTY 50 that have over 100 subsidiaries with several of these outside India. In the past, IiAS has protested against debt being raised in subsidiaries not requiring the shareholders' approval - in the listed entity. For example, if L&T raises debt for one of its projects that is being held in a special purpose vehicle (SPV), the board (or even management) of L&T

can decide this quantum unilaterally, without shareholder approval. When shareholders approve borrowing limits of companies, it is only for the standalone entity. As a result, shareholders do not have control over consolidated debt – they can only hope that the board of the listed holding company is prudent in raising debt across subsidiaries (Exhibit 1: Standalone debt vs consolidate debt of NIFTY 50 companies on 31 March 2018). The same logic extends to remuneration from subsidiaries (UPL Limited) and related party transactions that take place through unlisted subsidiaries (the Rs.1.25 bn Cairn-Vedanta loan).

IiAS believes that consolidated financial metrics is a prudent method of defining parameters. When investors buy equity in a company, they are buying equity in the entire structure – a Tata Motors Limited's shareholder is equally invested in the performance of Jaguar Land Rover (JLR) and not simply with the domestic business. Only factoring in the standalone financial statement misses the bigger picture.

Notwithstanding the arguments, if L&T appeals SEBI's order, the debate is likely to focus on the intent of the regulation and the letter of the law. Prescriptive regulation tends to create such ambiguity – and more so because SEBI (Share Based Employee Benefits) Regulations, 2014 do not specifically mention that the 2:1 debt-ratio related to consolidated debt / consolidated equity. In carefully wording the regulations, such conflicts can be avoided: regulators need to make clear the intent of their regulation while crafting them.

Exhibit 1: Debt levels of NIFTY 50 companies on 31 March 2018

Sr. No.	Company Name	Standalone Debt (Rs. Bn.)	Consolidated Debt (Rs. Bn.)	Consolidated / Standalone (x)
1	Adani Ports and Special Economic Zone Ltd.	201.19	222.04	1.10
2	Asian Paints Ltd.	0.11	5.33	47.25
3	Axis Bank Ltd.	1,480.16	1,557.67	1.05
4	Bajaj Auto Ltd.	1.21	1.21	1.00
5	Bajaj Finance Ltd.	623.93	654.77	1.05
6	Bajaj Finserv Ltd.	-	647.19	-
7	Bharat Petroleum Corporation Ltd.	233.51	376.59	1.61
8	Bharti Airtel Ltd.	654.16	1,113.34	1.70
9	Bharti Infratel Ltd.	-	-	-
10	Cipla Ltd.	1.75	40.98	23.48
11	Coal India Ltd.	-	15.38	-
12	Dr. Reddy's Laboratories Ltd.	25.89	50.71	1.96
13	Eicher Motors Ltd.	0.86	1.51	1.75
14	GAIL (India) Ltd.	20.81	32.20	1.55

Sr. No.	Company Name	Standalone Debt (Rs. Bn.)	Consolidated Debt (Rs. Bn.)	Consolidated / Standalone (x)
15	Grasim Industries Ltd.	29.69	672.04	22.64
16	HCL Technologies Ltd.	0.48	5.59	11.65
17	HDFC Bank Ltd.	1,231.05	1,564.42	1.27
18	Hero MotoCorp Ltd.	-	2.28	-
19	Hindalco Industries Ltd.	202.97	520.74	2.57
20	Hindustan Petroleum Corporation Ltd.	209.91	219.52	1.05
21	Hindustan Unilever Ltd.	-	-	-
22	Housing Development Finance Corporation Ltd.	3,199.12	3,366.30	1.05
23	ICICI Bank Ltd.	1,828.59	2,294.02	1.25
24	Indiabulls Housing Finance Ltd.	1,066.08	1,135.55	1.07
25	Indian Oil Corporation Ltd.	580.30	656.50	1.13
26	IndusInd Bank Ltd.	382.89	382.89	1.00
27	Infosys Ltd.	-	-	-
28	ITC Ltd.	0.18	0.36	2.00
29	JSW Steel Ltd.	365.19	398.69	1.09
30	Kotak Mahindra Bank Ltd.	251.54	586.04	2.33
31	Larsen & Toubro Ltd.	105.61	1,075.24	10.18
32	Mahindra & Mahindra Ltd.	29.58	558.98	18.90
33	Maruti Suzuki India Ltd.	1.66	1.76	1.06
34	NTPC Ltd.	1,216.06	1,300.50	1.07
35	Oil & Natural Gas Corporation Ltd.	255.92	1,061.58	4.15
36	Power Grid Corporation of India Ltd.	1,312.13	1,315.03	1.00
37	Reliance Industries Ltd.	1,168.81	2,196.33	1.88
38	State Bank of India	3,621.42	3,690.79	1.02
39	Sun Pharmaceutical Industries Ltd.	68.84	103.85	1.51
40	Tata Consultancy Services Ltd.	2.25	2.47	1.10
41	Tata Motors Ltd.	184.64	889.50	4.82
42	Tata Steel Ltd.	281.26	921.47	3.28
43	Tech Mahindra Ltd.	2.55	23.97	9.41
44	Titan Company Ltd.	-	0.79	-
45	Ultratech Cement Ltd.	174.20	194.80	1.12
46	UPL Ltd.	11.22	66.38	5.92
47	Vedanta Ltd.	407.13	581.59	1.43
48	Wipro Ltd.	58.03	138.26	2.38
49	Yes Bank Ltd.	748.94	748.94	1.00
50	Zee Entertainment Enterprises Ltd.	15.27	15.28	1.00
	Total	**22,257.06**	**31,411.36**	**1.41**

Source: ACE Equity

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