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SEBI's Rejection of L&T's Buyback Proposal

Why in news?

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The Securities and Exchange Board of India (SEBI) recently rejected Larsen and Toubro’s (L&T's) proposal to buy back part of its shares.

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What is the buyback mechanism?

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- Buyback of shares refers to the repurchasing of shares of stock from the market by the company that issued them.
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- A company prefers buyback usually when it has a significant cash reserve and feels that the shares are not fairly valued at the current market price.
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- The brought back shares will have increased Earnings Per Share (EPS) by default.
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- It's because a buyback is usually done at a price higher than the then prevailing market price and so shareholders get an attractive exit option.
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- A company can use a maximum of 25% of the 'aggregate' of its free reserves and paid-up capital for a buyback.
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What is the L&T case?

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- Larsen and Toubro, an engineering group, had sought the permission of SEBI to purchase 6.1 crore shares from its shareholders.

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- The stated intent of the company was to improve shareholder return by purchasing the shares above the traded price.
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- The buyback proposal has, however, been rejected by the SEBI.
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- It stated that the company's consolidated debt-to-equity ratio after the buyback would be above the limit stipulated in the regulations.
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What is the dispute here?

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- L&T has stated that it considered the post-issue debt-to-equity ratio of the standalone entity before moving the proposal forward.
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- With the parent entity holding negligible debt on its books, the ratio after the issue was well within permissible limits.
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- The 'aggregate' secured and unsecured debts owed by the company after the buyback and the paid-up capital and free reserves should be used for arriving at the debt equity ratio.
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- This is as per the requirements specified in SEBI's buyback of securities regulation, 2018 as well as the Companies Act, 2013.
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- SEBI, thus, considered the debt of the L&T's consolidated entity, including the share of the subsidiaries.
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- It, hence, concluded that the company has failed the post-issue debt-equity ratio test.
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- The word 'aggregate' is open to several interpretations here and so the company cannot refute the regulator's objection.
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Is the rejection justifiable?

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- The regulator cannot be faulted for taking a more holistic view of the group

finances after the recent experience in the IL&FS issue.
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- In the IL&FS issue, most creditors and credit rating agencies had erred, considering only the standalone numbers.
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- So a better scrutiny of numbers by the regulator is certainly welcome.
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- It is a signal that the SEBI is vigilant about protecting investors' interests and improving corporate governance.
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- However, Larsen and Toubro was also not wrong in interpreting the buyback rules as referring to the debt and equity of the parent alone.
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- Investors who would have already purchased shares of the company in anticipation of the buyback stand to lose now.
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- Also, the company will have to look at alternative routes to reward its shareholders, which might not be as tax-efficient as share buyback.
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What is the need now?

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- Rules and regulations need to be spelled out in an unambiguous manner so that companies and investors are clear about it.
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- SEBI needs to spell its stance clearly on the numbers to be considered in a buyback.
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- It would also help if the regulator took a closer look at the composition of the group debt.
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- SEBI can see if the numbers were elevated due to the nature of business of a group company.
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Source: Business Line

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