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IDFC Bank finds itself a new suitor

IDFC Bank rested its survival on obtaining a bank licence. Having gained a licence, it failed to capitalize on it and for the past two quarters has scrambled for a fix.

IDFC Bank rested its survival on obtaining a bank licence. Having gotten one, it failed to capitalize on its this and for the past two quarters has scrambled for a fix.

Six months ago, the Shriram group was the placebo, now its Capital First Limited (Capital First). The haste with which IDFC Bank has changed partners, begs the question whether IDFC Banks' and IDFC's board have understood the contours of what has been proposed, and asked the managements the right questions.

1. IDFC had a board meeting on 12 January in which this transaction was discussed. Given that this is a material subsidiary, why were the stock-exchanges not informed?
    a. Vinod Rai was unable to attend this meeting and did so by video-call. He had not attended the earlier meeting where the Shriram deal was finalized. The urgency to hold both the important meetings in his absence is not clear. His physical presence may have shaped a different route to dilution and maybe a different outcome.
2. The RBI banking license requires IDFC to hold 40% equity in IDFC Bank. The proposed exchange ratio will result in IDFC's holding in IDFC Bank dropping below 40% to 36.2% (and not 37.6% as has been mentioned, as explained below).
    a. Is it correct for IDFC's board to second guess the regulator and assume that they will get permission to dilute below 40%? Uday Kotak's experience is that RBI draws a red line which cannot be crossed.
    b. The board has assumed that this is what its shareholders want: The Shriram experience suggests this is not so. Could this be why IDFC Limited is not a part of this equation? Will it ask its shareholders to vote on this? It should.
3. If IDFC is diluted below 40%, and then needs to top-up its shareholding, will it do so before or after the merger? In either case, it will be in breach of RBI's licensing conditions, unless they are able to get a waiver – in which case, Kotak should expect the same.
    - At the exchange ratio announced, IDFC will have to spend ~ Rs 7.67 bn to take its shareholding to 40%.

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Note: This version has all numbers including in the exhibits in billion. Point 3 in the earlier version also referred to IDFC Bank as having to spend to increase its shareholding. This should be IDFC.

- If you factor in ESOPs to V Vaidyanathan, IDFC will have to spend ~ Rs 10.78 bn (including 7.5 mn options outstanding on 31 March 2017 and 1.5 mn options proposed to be granted under CMD Stock option scheme-2017); and
- if you factor in all stock options (exercisable options on 31 March 2017 and fresh options under ESOS-2017 and CMD stock option scheme-2017, IDFC will need to spend Rs 12.19 bn.
    a. Does IDFC have this surplus cash? Is this the best use of borrowed funds? Will the President of India – and other shareholders not prefer to receive this as dividend?
    b. The above assumes that the share price will be at current levels. Should it run-up knowing that IDFC has to buy equity on the market to reach 40%, pain will be more.

4. Is this the right time to do a merger? IDFC Banks shares trade at 1.5 times its book value (on 30 September 2017) while Capital First at 3.4 times. Any merger will be detrimental to the interest of IDFC/ IDFC Banks' shareholders.

Why was IDFC setup?

It is important to understand the context in which IDFC was set-up.

By the mid-1990's, the erstwhile DFIs - development finance institutions - ICICI Limited, IDBI Limited, IFCI Limited faced two unusual challenges. They had grown too large for the banking system to support their growth – their bonds had lost the SLR status that had fueled decades of growth, leading to exposure issues for their lenders. The unshackling of the economy meant an end of the license raj. This along with the opening-up of imports, resulted in stress in the corporate sector which was mirrored in the DFI balance sheets, making fund raising that much more challenging. ICICI and IDBI countered this by first obtaining banking licenses and then merging the DFI business (- only labelling is DFI was no longer correct) with the banks. (IFCI was too bullet-ridden and too small to make the transition).

Liberalization led to another change - infrastructure was no longer the preserve of the government – the private sector was encouraged to step in. As the DFIs had stepped back from offering long-term finance, this gap needed to be filled. This is when IDFC was set-up in 1997. While the government remit remained infrastructure financing, the company slowly expanded to private equity and then asset management. Pretty soon, IDFC was singing the same song as the DFIs: it needed a bank to fuel its growth. In 2014, RBI gave it a license to set-up a bank.

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5. IDFC Bank shares trade at the lowest Price to book of any 'new private sector bank' (Exhibit 1). This was an obvious first place for the board to start asking questions.
6. Based on the exchange ratio and market price, IDFC Bank is 'acquiring' an entity with Rs 24.2 bn. of net worth (on 30 September 2017) for Rs 93.11 bn. Is the Rs. 68.91 bn. premium or the acquisition price justified? Put this another way, IDFC Bank is paying Rs 93.11 bn to acquire assets of Rs 229.74 bn Acquiring a CEO to steer the ship should never be so expensive.
7. The deal economics are expected to kick in after 36 months. A lot can happen in between. The best option was to build the business brick-by-brick. The market provides - and always has, opportunities for those who are well positioned. Bandhan Bank which was licensed at the time of IDFC bank and RBL Bank which saw a new management team move in a bit earlier, both have succeeded (- see Exhibit 2 and 3: IDFC Bank vs Bandhan Bank Vs RBL Bank).
8. Rajiv Lall spoke of paying a 12.6% premium to acquire the shares of Capital First. But the CEO of Capital First will now be the CEO of IDFC Bank, and Rajiv Lall moves-up to Chair. Make no bones, IDFC Bank has been acquired. Th question is why pay a premium to get acquired?
9. IDFC's holding in IDFC Bank will fall to 40% (- maybe even lower). Will it allow IDFC Bank to use the IDFC brand given that it is no longer a subsidiary? If so, will it like HDFC charge the bank a royalty fees? This should surely be on the table.
10. Since the bank will no longer be a subsidiary, it's governance framework and structure will now need an overhaul. Some clarity on this was needed.

If today HDFC Bank and Kotak Bank command a premium it is because they have built their business brick-by-brick. And because they command a premium they are acquirers. The acquisitions bring down the key ratio's from there stratospheric highs, attracting new investors. This is the virtuous circle to emulate. There are no short-cuts.

Exhibit 1: Price/Book Ratio for Banks

S. No.		Name	Price/Book (x)
1	P	Kotak Mahindra Bank Ltd.	5.59
2	P	HDFC Bank Ltd.	5.14
3	P	IndusInd Bank Ltd.	4.43
4	P	RBL Bank Ltd.	3.47
5	P	Yes Bank Ltd.	3.28
6		City Union Bank Ltd.	3.01
7	P	Axis Bank Ltd.	2.55
8		DCB Bank Ltd.	2.46
9	P	ICICI Bank Ltd.	2.15
10		The Federal Bank Ltd.	1.72
11		Karur Vysya Bank Ltd.	1.44
12	P	IDFC Bank Ltd.	1.36
13		The Lakshmi Vilas Bank Ltd.	1.28
14		The South Indian Bank Ltd.	1.19
15		Dhanlaxmi Bank Ltd.	0.91
16		The Karnataka Bank Ltd.	0.88

P: New private sector bank; RBL has been included in this on account of management change

Source: Ace Equity

Exhibit 2: Key financials (Rs. bn)

Bank	Bandhan Bank Ltd.		IDFC Bank Ltd.		RBL Bank Ltd.	
Particulars	**Mar-16**	**Mar-17**	**Mar-16**	**Mar-17**	**Mar-16**	**Mar-17**
Networth	33.3	44.5	136.3	146.8	29.9	43.4
Deposits	120.9	232.3	82.2	402.1	243.5	345.9
Borrowings	30.5	10.3	571.6	502.6	105.4	79.8
Other liabilities & provisions	12.8	15.3	42.0	70.1	12.9	17.7
Total liabilities	**197.6**	**302.4**	**832.2**	**1,121.6**	**391.6**	**486.7**
Investments	37.6	55.2	297.3	504.7	144.4	134.8
Advances	124.4	168.4	457.0	494.0	212.3	294.5
Other assets	35.6	78.8	77.9	122.9	35.0	57.4
Total assets	**197.6**	**302.4**	**832.2**	**1,121.6**	**391.6**	**486.7**

Source: Ace Equity

Exhibit 3: Key ratios

Bank	Bandhan Bank Ltd.		IDFC Bank Ltd.		RBL Bank Ltd.	
DESCRIPTION	**Mar-16**	**Mar-17**	**Mar-16**	**Mar-17**	**Mar-16**	**Mar-17**
Earnings Per Share (Rs)	2.5	10.2	1.4	3.0	9.0	11.9
Yield on Advances (%)	12.7	23.2	8.0	17.3	12.9	12.6
Yield on Investments (%)	3.5	8.2	5.3	7.6	5.6	8.2
Cost of Liabilities (%)	4.3	6.2	4.3	7.2	5.5	5.9
NIM (%)	4.8	8.1	1.1	1.9	2.1	2.6
ROA (%)	2.8	4.4	1.1	1.0	0.9	1.0
ROE (%)	14.4	28.6	6.9	7.2	11.2	12.2
Advances Growth (%)	-	35.4	-	8.1	46.9	38.7
CASA (%)	21.6	29.4	5.4	5.2	18.6	22.0
Net NPAs (funded) to Net Advances (%)	0.1	NA	2.4	1.1	0.6	0.6
Gross NPAs to Gross Advances (%)	NA	NA	6.2	3.0	1.0	1.2

Source: Ace Equity

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