

"A man is
great by
deeds, not by
birth"

-Chanakya

Welcome to IIMK



INDIAN INSTITUTE OF MANAGEMENT KOZHIKODE



Case Study

IIMK/CS/108/FIN/2019/03

MARCH 2019

IDFC Bank and Capital First – A Case of Merger Arbitrage

Jijo Lukose P.J.¹

¹Associate Professor, Finance, Accounting and Control, Indian Institute of Management, Kozhikode, IIMK Campus PO, Kunnamangalam, Kozhikode, Kerala 673570, India; Email: jijo@iimk.ac.in, Phone Number (+91) 495 – 2809253

IDFC Bank and Capital First – A Case of Merger Arbitrage

Six months into his dream job at Capitell Mr. Anand Agarwal, a recent MBA graduate from one of the top business schools in South India is contemplating on the pitch he has prepared to his boss. As Anand is taking a long walk on the late hours on Sunday, 14th January on Marine drive with the ocean to his left, his thoughts are preoccupied at the report he has prepared.

Capitell Inc. and the paradigm shift

Capitell Pvt. Ltd. is a category III - Alternative Investment Funds (AIFs) registered with SEBI whose main business ploy is profiting through long-short equity, and volatility arbitrage. Volatility Arbitrage involves maintaining delta neutral portfolios to take advantage of differences between the implied volatility of the option, and future realized volatility of the option's underlying. Traditionally, its parent firm Capitell Inc. a hedge fund with AUM of 11.4 billion USD focuses on inefficiencies in US and emerging equity markets. Capitell Inc. has returned 14.76% net of fees in 2017 better than the average return (8.5%) produced by hedge funds¹. Sustainability in this industry is a direct function of an organization's propensity to adapt to dynamic changes in capital markets. In that regard, Capitell Inc.'s board recently voted in favor of a paradigm shift where Capitell, apart from existing strategies, also slowly focus on 'event driven' arbitrage². Mr. Richard Holmes, a successful wall street fund manager has been roped in specifically for this, and his main task to set up and build event-based arbitrage strategies. Richard's first recruit in this division is Anand, who has been tasked with identifying potential arbitrage opportunities.

IDFC's press release – An Opportunity?

While browsing through www.moneycontrol.com on the 10th of January, 2018, Anand spotted a particular news item titled "*IDFC Bank, Capital First explore merger: Talks at initial stage; deal will help bank tap into 5 million retail & SME customers of latter*". Having read this news item, Anand decides this is the chance to kick start his firm's new philosophy of event-based arbitrage. On the next day i.e. 11th January 2018 (Thursday), the company secretary of IDFC Bank Ltd. Mr. Mahendra N. Shah wrote a letter of clarification to the National Stock Exchange of India (NSE) Ltd. providing clarification on this news item that had been in circulation the day before. IDFC Bank neither accepted nor denounced the news item in the press release. The neutral tone of the press release immediately became of importance to Anand, because this potentially provided him with an opportunity to strategize what his firm was looking for. Anand believed that should the reported rumors of IDFC Bank-Capital First merger was happening, Capitell had a chance to profit on this potential event (in this case Merger). As Anand read the letter again on 11th January 2018, he had made up his mind on his next course of action.

¹See Hedge funds produce best returns in 4 years

(<https://www.forbes.com/sites/nathanvardi/2018/04/17/the-25-highest-earning-hedge-fund-managers-and-traders-3/#30de45b53596>)

² Event driven arbitrages are arbitrage opportunities that arise due to unanticipated events (like potential merger announcements).

While Anand was formulating his strategic pitch to Richard on the potential during the entire Saturday, the 13th of January 2018, IDFC issued a second press release on the weekend formally announcing the merger. The boards of directors at IDFC bank and Capital first held meetings on 13th January, and after the meeting, a merger between IDFC bank and Capital First Ltd., Capital First Home Finance Ltd., and Capital First Securities Ltd., was communicated with the NSE³.

The Back Story – IDFC Bank Limited

IDFC Bank is part of IDFC Ltd. an integrated infrastructure firm incorporated in 1997 with a registered office at Chennai, India. In 2014, to confirm with RBI guidelines, IDFC Financial Holding Ltd. was formed as a holding company managing five of IDFC's subsidiaries, including IDFC Bank. As a commercial bank, it mainly focused on corporate banking, retail banking and rural banking. Though IDFC bank provides commercial and wholesale banking solutions to corporations, MNCs, SMEs, government and other institutions, it also emphasizes on providing services to the rural sector and entrepreneurs.

The Back Story – Capital First Limited

Capital First Ltd., founded in 2005 is a non-bank financial institution (NBFC) primarily providing debt-based financing to micro, small and medium enterprises (MSME). Its primary product portfolio includes personal loans, business loans, loans against property/mortgage, two-wheeler loans, pre-owned car loans and insurance. Capital First majorly focused on providing financial services to the unorganized sector.

The Merger Arbitrage Opportunity

While the rest of the market was focusing on the synergy between these two firms – especially on the clientele side, Anand had other ideas. Anand believed that this merger, potentially a stock based merger could provide him with the ideal set up to pitch an arbitrage opportunity. After seeing the second press release confirming the merger, Anand immediately set up to design an arbitrage strategy where Capitell would short shares of IDFC Bank Ltd. and go long on Capital First Ltd. Anand had three major risks to ponder before pitching his final report to Richard.

The Three Concerns

One of Anand's primary concern was the duration taken for stock swap transactions in India to get finalized. In recent times, Waterbase Ltd.'s acquisition of Pinnae Feeds Ltd. took almost two years from the date of announcement (25-08-2015) to the date of completion (27-11-2017). In addition, Dish TV India had announced the acquisition of Videocon d2h Ltd. on 11th November, 2016, but as of January 13th, 2018, the deal was yet to be consummated. Second, IDFC Bank had officially scrapped the merger planned with Shriram Capital in October 2017 after almost four months of negotiation as both firms could not find acceptable stock swap ratios. In addition, such deals in India must go through several regulators including SEBI and RBI. Finally, naked short selling is illegal in India, as regulations stipulate that all short sales

³ IDFC bank and Capital First announce merger – formal press release

must result in delivery. Though IDFC Bank-Capital First merger provided a ripe chance for Anand and Capitell to strategize on event-driven arbitrage, the risks were also high.

To Short-Long or Skip?

On Monday, the 15th of January, 2018 Anand has to make a decision given the recent announcements about IDFC Bank and Capital First. Anand also has the following data available to him provided in the exhibits provided below.

Discussion Questions:

1. What are the motives for the deal?
2. After failing to complete a merger following the last attempt noted in the case, why should the proposed transaction be successful this time?
3. What was the price of First Capital before the announcement and what is the offered price. Estimate the “merger premium,” and compare this with “deal spread.”
4. Capital First closed at a price of Rs64.25 per share and IDFC bank closed at Rs.845.6 on January 15, 2018 (the first trading day after the offer was announced). What does this price say about the implied risk neutral probability of the transaction going through?
5. As an event-driven investment manager, what kind of information or research do you think is most valuable in evaluating this type of opportunity? What is your estimate of probability that the transaction going through? What are the other risks that Capitell will be taking if they go for Merger Arbitrage?

EXHIBIT 1: Press release

IDFC Bank and Capital First announce Merger

□□ *Announcement is pursuant to IDFC Bank's stated strategy of "retailising" its business and transforming into a well-diversified universal bank; and in line with Capital First's stated intention and strategy to convert to a universal bank*

□□ *Post-merger, the combined entity of IDFC Bank and Capital First will have an AUM of Rs 88,000 crores and will serve more than five million customers across the country*

Mumbai, January 13, 2018: IDFC Bank and Capital First today announced that the Boards of Directors of IDFC Bank and Capital First at their respective meetings held on January 13, 2018, approved a merger of Capital First with IDFC Bank.

Pursuant to the merger which is subject to regulatory and shareholder approvals, IDFC Bank will issue 139 shares for every 10 shares of Capital First.

This announcement is pursuant to IDFC Bank's stated strategy of "retailising" its business to complete their transformation from a dedicated infrastructure financier to a well-diversified universal bank, and in line with Capital First's stated intention and strategy to convert to a universal bank.

Capital First brings with it a retail lending franchise with a loan book of Rs 22,974 crores (September 2017), a live customer base of three million customers; and a distribution network in 228 locations across the country growing at a five-year CAGR of 27% on AUM and 40% in profits, with gross and net NPA at 1.63% and 1.0% respectively.

Post-merger, the combined entity of IDFC Bank and Capital First will have an AUM of Rs 88,000 crores; PAT of Rs 1268 crores (FY 17); and a distribution network comprising 194 branches (as per branch count of December 2017 of both entities), 353 dedicated BC outlets and over 9,100 micro ATM points, serving more than five million customers across the country.

Mr. Vaidyanathan, currently Chairman and MD of Capital First, will succeed Dr. Rajiv Lall as MD and CEO of the combined entity upon completion of the merger and necessary regulatory approvals.

Over the past 13 years Dr. Rajiv Lall has led the growth of the IDFC Group variously, as MD and CEO of IDFC Ltd. from 2005-13, as Executive Chairman of IDFC Group from 2013-15, and as Founding MD and CEO of IDFC Bank from 2015 to the present. Post-merger Dr. Lall will step into the role of non-executive Chairman of IDFC Bank, subject to regulatory approvals, and guide the transition process. He will replace Ms. Veena Mankar who will remain on the Board.

Mr. Vaidyanathan founded Capital First by a Management Buyout of an existing listed NBFC and has built an institution specialising in financing small entrepreneurs and consumers, based on new age technologies and has increased the market capitalization of Capital First ten-fold since the buyout, from Rs. 780 Crores (March 31, 2012) to over Rs. 8000 Crores.

Dr. Lall said: "We believe this merger will be transformational for IDFC Bank. It will bring two tech savvy, culturally aligned platforms to come together to create a diversified and fast growing universal bank with a national footprint, in a manner that will be value accretive for all shareholders. Vaidya has built a terrific franchise and team. He comes with a proven track record, the right experience and the leadership skills to firmly establish the combined entity amongst the highest echelons of Indian banking."

Mr. Vaidyanathan said: “I have tremendous respect and admiration for Rajiv and what he has built at IDFC Bank. On our part, we have always said publicly that a banking platform provides a stable diversified liability base and is hence critical for building a large franchise. We are excited about this merger because IDFC Bank provides a perfect platform for continued growth of the combined franchise, supported by low-cost funding.”

Mr Vishal Mahadevia, Head Warburg Pincus India, said: “It has been a terrific journey over the past five plus years watching Vaidya lead Capital First from a virtual startup to one of the premier retail and MSME financiers in the country. A merger with the IDFC platform that has been built by Rajiv and his team creates a powerful combination. We are excited about the opportunity to be part of something special here, and look forward to supporting Vaidya and the teams at Capital First and IDFC Bank as they grow the platform into a leading banking institution in the country.”

For queries, please contact:

IDFC Bank
Dr. NS Rajan
ns.rajan@idfcbank.com
9810110525

Capital First
Pradeep Natarajan
Pradeep.natarajan@capitalfirst.com
9967068259

EXHIBIT 2: Closing Share Prices and Index Values

	Date	Closing Share Price		Nifty
		Capital First Ltd.	I D F C Bank Ltd.	
One year before	13-Jan-17	610.8	63.25	8400.35
6 months before	14-Jul-17	749.45	62.75	9886.35
3 months before	13-Oct-17	754.7	59.2	10167.45
2 months before	14-Nov-17	701.4	55.3	10186.6
1 month before	14-Dec-17	665.1	52.1	10252.1
15 days before	29-Dec-17	692.95	54.25	10530.7
5 Days before	08-Jan-18	771.55	63.35	10623.6
4 Days before	09-Jan-18	782.55	62.8	10637
3 Days before	10-Jan-18	792.9	63.25	10632.2
2 Days before	11-Jan-18	835.7	68.55	10651.2
1 Day before	12-Jan-18	837.5	67.5	10681.25
After the announcement	15-Jan-18	845.6	64.25	10741.55
2 days after	16-Jan-18	785.2	60.05	10700.45

EXHIBIT 3: Financials of I D F C First Bank Ltd. (Rs. Million)

	Mar-16	Mar-17
Total income	40,889.40	1,11,632.40
Income from financial services	40,428.20	95,424.70
Fee based financial services income	677.4	2,992.80
Fund based financial services income	39,750.80	92,431.90
Total expenses	36,220.90	1,01,435.00
Fund based financial services expenses	28,224.80	83,835.00
Compensation to employees	2,566.30	5,736.20
Provisions	400.8	233.4
Prior period and extraordinary expenses	438.4	53.5
Provision for direct tax	2,051.10	4,525.00
Profit after tax (PAT)	4,668.50	10,197.40
Total liabilities	8,33,333.80	11,23,550.40
Shareholders' funds	1,36,325.50	1,46,780.60
Deposits	82,190.40	4,02,082.30
Borrowings	5,71,598.40	5,02,621.80
Current liabilities & provisions	42,044.40	70,112.00
Total assets	8,33,333.80	11,23,550.40
Net fixed assets	6,436.40	7,811.80
Investments	3,00,036.20	5,04,717.00
Current assets	47,402.60	96,138.10
Loans & advances	4,61,150.90	5,00,560.60
Cash and bank balance	29,039.00	51,020.10

EXHIBIT 4: Financials of First Capital Ltd. (Rs. Million)

	Mar-16	Mar-17
Total income	18,503.50	27,289.10
Income from financial services	18,472.20	27,180.30
Fee based financial services income	2,114.70	3,754.40
Fund based financial services income	16,357.50	23,425.90
Total expenses	16,934.40	25,120.50
Fee based financial services expenses	575.3	1,117.60
Fund based financial services expenses	8,762.40	11,279.10
Compensation to employees	1,790.90	2,358.90
Provisions	209.7	479
Provision for direct tax	837.8	1,156.30
Profit after tax (PAT)	1,569.10	2,168.60
Total liabilities	1,41,065.70	1,70,239.00
Shareholder's funds	14,456.00	19,784.20
Non-current liabilities	73,384.90	88,798.90
Long term borrowings	70,942.10	86,045.90
Current liabilities (incl short term provisions)	51,083.40	59,068.10
Total assets	1,41,065.70	1,70,239.00
Non-current assets	86,667.30	94,588.00
Net fixed assets	292.4	646.4
Long term investments	2,223.20	2,953.20
Long term loans and advances by finance cos	80,372.10	87,692.80
Current assets (incl short term invest & adv)	54,398.40	75,651.00

Research Office

Indian Institute of Management Kozhikode

IIMK Campus P. O.,

Kozhikode, Kerala, India,

PIN - 673 570

Phone: +91-495-2809237/ 238

Email: research@iimk.ac.in

Web: <https://iimk.ac.in/faculty/publicationmenu.php>

