The Hindu Business Line – The fundamentals of the HDFC HDFC Bank merger – 06.08.2022

The fundamentals of the HDFC-HDFC Bank merger

BL Explainer

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What is the rationale behind the merger of HDFC and HDFC Bank?

Rumours around the HDFC-HDFC Bank merger date back to 2014. So the deal has been in the works for many years. HDFC and HDFC Bank have an agreement whereby the parent company will sell a certain portion of its loans to the bank every quarter. For the bank, this was the only exposure to the home loans business. Therefore, owing to the complementary nature of businesses and the cost synergies, particularly for the home loan business, the deal made sense to both.

Ever since the 2018 IL&FS crisis, RBI has been pushing non-banking financial companies (NBFCs) to work like banks — that is, set aside reserves as a precaution, ensure a wider base of liabilities, and so on; beyond a certain threshold (₹50,000 crore), operating as an NBFC could become challenging. HDFC Chairman Deepak Parekh's own admission is that the bank-like regulations for NBFCs were the final nudge for the merger.

How will the merger be beneficial?

HDFC Bank's loan book is currently at ₹12-lakh crore. Organically climbing to ₹18-lakh crore can be a daunting task — one that would involve tightrope walking between growth, profitability and asset quality. Hence, roping in a 'known (and parent) devil' — HDFC Limited — is an easier and economical option.

For the bank, the share of home loans in its total book would zoom to 33 per cent from 11 per cent now. The merger would make HDFC Bank India's second largest bank. While the gap between HDFC Bank and SBI would be about ₹6-7-lakh crore, ICICI Bank would be a distant third with a gap of over ₹10-lakh crore. So HDFC Bank's position is quite cemented.

What is the swap ratio? When will the merger take effect?

Given the complexity involved, as all HDFC Group subsidiaries will now fold into the bank, the merger requires several regulatory okays. That could take 14-18 months; the deal is likely to be completed by the end of FY24. For every 25 shares held in HDFC Limited, 42 shares of the bank will be allotted. The swap ratio works to 1:1.68.

Will it result in cost optimisation?

In the long run, yes. Starting from cost of operations to cost of pricing loans and cost of running the establishment, everything will reduce. But these synergies could take a while to accrue; perhaps by FY26 or so.

But in the near term, by FY25, if the merged entity becomes operational, the merger could be a drag on HDFC Bank. With the cost of statutory reserves increasing and a slightly low-yielding housing finance book getting clubbed with a loan book generating a net interest margin of four per cent, HDFC Bank's financials may not look good in the initial years of operations post the merger.

What do stakeholders gain from this move?

Investors of HDFC Limited will get shares of HDFC Bank and given the premium the bank trades at to the holding company, this is a good deal for them. Investors of HDFC Limited will get 41 per cent shares in the merged bank.

For shareholders of HDFC Bank, despite the unavoidable drop in profitability and return ratios, the merger gives access to a large loan base, which, in turn, acts as a natural shield against asset quality.

If there is trouble in certain pockets of the business, say the agri loans or the MSME book, the asset quality of these loans will not disturb the overall asset quality of the bank due to the diversified loan book it will get through the merger.