IDFC Limited IDFC IN

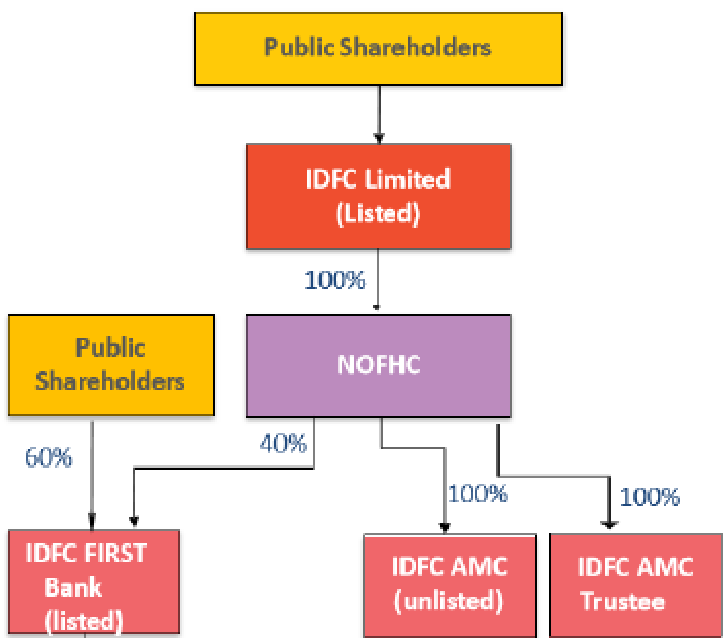
November 28, 2019 - 12:53am EST
by Sandrokottos

			2019	2020
Price:	33.65	EPS	0	0
Shares Out. (in M):	1,596	P/E	0	0
Market Cap (in $M):	750	P/FCF	0	0
Net Debt (in $M):	0	EBIT	0	0
TEV ($):	0	TEV/EBIT	0	0

Description

IDFC IN is an interesting risk/reward special situation. The stock has been a perennial underperformer for many years. However, it seems the end-game is now near and value unlocking will happen over the coming 18-24 months.

After a long journey of divesting non-core assets and cleaning up the structure (see below), IDFC IN is now left with three primary assets (a) 40% stake in IDFC First Bank (IDFCFB IN), (b) 100% stake in IDFC AMC and (c) cash and cash equivalents.



IDFC IN trades at a 50-60% HoldCo discount, depending on the value assigned to the unlisted AMC. Under normal circumstances, HoldCo discounts in India are deserved as some of these structures are designed to help promoters keep control of conglomerates and will perhaps never get simplified. However, in the case of IDFC, there is a professional management in place that is working towards unlocking value, breaking up the SOTP and getting the value to shareholders directly, in the form of shares of the underlying bank and AMC, or cash.

There are regulatory constraints and uncertainties which makes a fully efficient unlocking difficult. There are various permutations depending on regulatory permissions/comfort. Under the assumption that IDFCFB IN price is unchanged (people can short it proportionally to hedge out the risk), I think the range of outcomes is roughly between INR 46 – 74 (+38%-120% vs. current price) over the coming two years or so. Let's look at the individual components one by one:

1/ Cash. IDFC plans to dividend out excess cash on the balance sheet by March 2020. They expect to have around INR 6,400m cash at the HoldCo available for a dividend. INR 3,000m is ready but they are awaiting the closure of certain non-core divestments for the remaining INR 3,400m. The deals have already been announced, and transfer of the final funds is expected soon. This would translate to ~INR 3.2 dividend per share by March 2020 (after dividend distribution tax). That is close to 10% of the current share price. IDFC has already returned ~INR 3 per share in dividends over the past couple of months. In my opinion, there is very little uncertainty about the remaining money getting to the hands of shareholders, hopefully before March 2020. In fact, there is a further INR 3bn or so in financial assets that can be liquidated in the future but have some lock-ins (I assume this is zero for this analysis).

2/ IDFC's stake in IDFCFB is worth around 83bn, or INR 52 per IDFC IN share. Clearly, if they manage to get these shares directly in the hands of IDFC shareholders, that is a ~60% upside on the stock immediately. The best case scenario for the value realisation in the bank would be for the NOFHC (see structure above) to be collapsed and for IDFC to be "reverse merged" with IDFCFB, so that IDFC shareholders get IDFCFB shares directly in their hands and thus realise INR 52 per share in value.

3/ IDFC AMC is a good asset that is growing fast. It is in the top 10 among mutual fund houses in India in terms of AUM. It has been gaining market share due to the excellent performance of its debt funds in the recent liquidity crunch / bad debts fiasco in India. AUM grew 14% QoQ in the September 2019 quarter and has now crossed INR 1 trillion as of October 2019 data. The AMC is on a run-rate of INR 900-1,000m PAT. There are various ways to value this:

i. HDFCAMC IN and RNAM IN are the two listed peers and are trading at high P/Es: 60x and 42x FY20 respectively. AMCs are the current flavour of the market in India due to the assumed long growth runway and high ROEs etc. Valuing IDFC AMC at 30x PE (half HDFCAMC multiple) would mean INR 30bn valuation (or INR 19 per IDFC share).

ii. There have been two recent AMC private market transactions: Mahindra AMC was sold at an implied valuation of ~10% of AUM, while IDBI AMC was sold at ~4% of AUM. Both only had INR 50bn in AUM. Applying these transaction comps yields a valuation of INR 40bn to INR 100bn for IDFC AMC. HDFC AMC trades at ~22% of AUM (they are the market leader and, well, HDFC).

iii. IDFC AMC was put up for sale in 2018. This was before HDFCAMC was listed and at a time when profitability of AMCs was uncertain due to SEBI regulation changes. IDFC AMC had depressed, non-normalised profitability at the time. AUM has grown 45% since then. As per media reports, they still got offers around INR 20-25bn in late 2018. Management deemed it too low, and chose to grow the business instead.

iv. In my base case, I am valuing IDFC AMC at INR 30bn, or INR 19 per share. This corresponds to 3% of AUM, or 30x PE. A clean listed or private market valuation could clearly be (materially) higher.

Thus, in an ideal world, if management manages to unlock value in a fully efficient way; shareholders will get (per share): 3 + 52 + 19 = 74 per share (+120% vs cmp). One can short the bank shares to hedge out the risk there. However, IDFCFB is a special situation in itself: IDFC Bank merged with Capital First a year ago. The new management (Capital First predominantly) has moved focus to retail loans and are aggressively growing the deposit base. The early signs are good. Profitability is low at present but is moving in the right direction. The stock trades at ~1.1x P/B. I would urge interested people to read the

IDFCFB FY19 annual report, where the new CEO has laid out his vision for the bank. If they pull it off, it could be an interesting story in itself. For example, if IDFCFB trades at 1.5x P/B in a couple of years (well-run retail banks trade at much higher multiples in India), that would itself be worth INR 72 per IDFC share.

Unfortunately, a simple spinoff of the bank and AMC shares is not straightforward due to the various regulatory hurdles in the way. The key regulatory bodies are:

i. Reserve Bank of India (RBI), the banking regulator

ii. Securities and Exchange Board of India (SEBI): the Indian version of the SEC.

iii. Central Board of Direct Taxes (CBDT)

I will try and explain the regulatory constraints as simply as possible, however it is impossible to explain without going into some intricacies :

i. IDFC has to hold *at least* 40% of the Bank until October 2020. This is part of a 5 year lock-in that started in October 2014 and is non-negotiable. Post October 2020, RBI guidelines say the stake *has to* reduce to 15% within a period of 15 years from the date of commencement of the bank. The 15% is not a lock-in, it is in fact designed to make sure that promoter stakes are brought down and the bank is widely held. The RBI, via the Small Finance Bank ("SFB") FAQs and new draft SFB guidelines has given further details on whether a promoter of a bank can fully "exit" the bank after the 5 year lock-in. The exact quote is: *"Whether a promoter ceases to be a promoter or could exit from the bank, after completing the lock-in period of five years, would depend on the RBI's regulatory and supervisory comfort / discomfort and SEBI regulations in this regard."* – RBI Draft SFB guidelines, September 2019. Thus, unless the language changes in the final guidelines (expected before March 2020), the RBI has left the question of complete promoter exit open to interpretation on a case by case basis. As it happens, IDFC has behaved impeccably (in the regulators eyes) over the years – that is the reason why it was the only entity that got an universal bank license when new licenses were issued in 2014 (it is extremely difficult to get a new universal banking license in India). IDFC has complied well with all RBI regulations since being granted the license (i.e. listing the bank within 3 years and bringing the stake down to 40% etc). In my opinion, the odds of RBI being comfortable with IDFC exiting the bank completely are fairly high.

ii. For the reverse merger to happen, the non-operating financial holding company ("NOFHC") through which IDFC holds IDFCFB needs to collapse. The initial banking license required this NOFHC structure. However, RBI has subsequently changed this, and a NOFHC is no longer required. However, for the NOFHC to be collapsed, the HoldCo cannot have any other group entities (i.e. the promoter HoldCo must only have the bank as a subsidiary). For ease of reference, the complete quote is: *"The requirement of Non-Operative Financial Holding Company (NOFHC) is not mandatory for individual promoters or standalone promoting/converting entities who/which do not have other group entities. Individual promoters/promoting entities/converting entities that have other group entities, shall set up the bank only through an NOFHC. Not less than 51 per cent of the total paid-up equity capital of the NOFHC shall be owned by the Promoter/Promoter Group. Specialised activities would be permitted to be conducted from a separate entity proposed to be held under the NOFHC subject to prior approval from the Reserve Bank and subject to being ensured that similar activities are not conducted through the bank. No shareholder, other than the promoters/promoter group, shall have significant influence and control in the NOFHC."* – RBI guidelines for "on tap" licensing for universal banks, 2016. This effectively means that IDFC will need to divest IDFC AMC before it can collapse the structure. In fact, I think IDFC management has been on a non-core asset divestment spree primarily to enable an eventual collapsing of the structure.

iii. Indian AMCs must have a 40% ParentCo stake as per SEBI regulations. As things stand, IDFC cannot spinoff the AMC directly to shareholders because then there won't be any "promoter" with a 40% stake. The options for the AMC are:

a. 60% spinoff to shareholders IF the reverse merger is not allowed by the RBI. Then IDFC can continue to hold 40% stake as the ParentCo, and then look to sell the remaining stake to a sponsor in future (and then dividend out the proceeds)

b. 100% private sale (and then dividend out the proceeds)

c. Transfer the AMC to a NewCo (such that the AMC is 100% owned by NewCo) and then spinoff the NewCo shares directly to shareholders. This will require SEBI comfort on NewCo qualifying as the ParentCo. While there is some uncertainty on this, my understanding is that this would be possible.

d. IPO 60% of the AMC and dividend out the proceeds

iv. There are also some (fairly arcane) requirements from the CBDT to ensure that spinoffs of subsidiaries are not treated as taxable dividends. In the case of spinning off 25% of bank shares directly to shareholders (40% to 15%), there may be some capital reduction issues which would allow a slightly lower stake spinoff (perhaps 23%).

v. Finally, IDFC's "buying price" for IDFCFB shares is ~INR 40 per IDFC share. However, the "grandfather" rate above which IDFC will be liable for capital gains tax is ~INR 56 (IDFCFB trades at INR 43 today). Thus, in the scenario where IDFC has to sell the bank shares and dividend out the proceeds, there will be capital gains tax applicable above INR 56 per IDFCFB shares (if we get that lucky).

It is difficult to predict what the final outcome will be. However, we can be fairly certain that *something* will happen in the next 12-24 months given the lock-up of the bank is expiring and management has publicly stated that they want to work towards unlocking value here (through various quarterly conference calls). The CEO also bought 100k shares from the market a few months ago (although not a large amount, it is worth noting nonetheless).

I will not lay out all the possible outcomes here as there are too many permutations. I will lay out the best and worst case scenario in my view (assuming IDFCFB share price is constant):

Best case:

. -Shareholders receive ~INR 3 in dividends by Feb/March 2020

. -RBI allows IDFC to go to 0% shareholding in the bank

. - IDFC transfers the AMC shares to NewCo and spins off those shares directly to shareholders

. -IDFC collapses the NOFHC and reverse merges with IDFCFB, giving IDFCFB shares directly to IDFC shareholders with no tax leakage

. -Shareholders make: 3 + 52 + 19 = INR 74 per share (ideally in 18-24 months)

Worst case:

. -Shareholders receive ~INR 3 in dividends by Mar/April 2020

. -RBI does not allow IDFC to go to 0% shareholding in the bank. IDFC sells 25% of the bank via block deals in the market starting October 2020 and dividends out the proceeds to shareholders after paying 20% dividend distribution tax. Shareholders get ~INR 26 per IDFC share in cash and still hold on to 15% stake in the bank, which presumably still attracts a 60% discount, so around INR 8 per IDFC share. This would get 26 + 8 = INR 32 per share

a. Note management could still explore ways to spinoff the 25% stake rather than selling and paying via dividends to be more tax efficient. However, we are working on worst case scenario for now, so I am assuming the tax leakage happens.

. -60% of IDFC AMC is spun off to shareholders directly. No NewCo is required since IDFC can stay as the ParentCo in this structure (and thus no fresh comfort from SEBI is required for NewCo). IDFC AMC market cap settles around INR 30bn (conservative for a growing business if we take the valuation 12-18 months from now). Shareholders get 60% of the market cap in their hands, i.e. INR 11.25 per share. The remaining 40% stake left with IDFC IN attracts a 60% discount, i.e. INR 3 per share. Thus, shareholders realise ~INR 14 per share for the AMC.

. - For conservatism, assume another INR 5bn i.e. INR 3 per share in costs, taxes etc that I can't envisage now.

. -Thus the "worst" case outcome is: 3 + 32 + 14 – 3 = INR 46 per share

I cannot predict how the story will unfold. My best guess is that the final outcome will be closer to the best case scenario (+120%) than the worst case scenario (+38%). I am also viewing this as a free option play on IDFCFB and IDFC AMC (I think both could be worth materially more in 2 years).

I do not hold a position with the issuer such as employment, directorship, or consultancy.
I and/or others I advise hold a material investment in the issuer's securities.

Catalyst

Lock-in expiry in October 2020

Various corporate actions (spinoffs, stake sales etc.)

IDFCFB and/or IDFC AMC performing better than expected

Messages

No messages