



Equitas Small Finance Bank - Special situation opportunity played out well

1 message

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The Equitas Holdings (EHL) - Equitas Bank Reverse Merger

Special situations opportunity that played out well in a volatile market

The background: Equitas Holdings stock IPOed in May 2016 at an issue price of Rs.110. The company was founded by P. N. Vasudevan who has been a director since its inception. He was earlier with Cholamandalam Investment and Finance Co Limited, part of the Murugappa Group. EHL was the holding company of Equitas Small Finance Bank (ESFB). ESFB's loan portfolio majorly comprises of Small Business Loans (37%), Vehicle Finance (25%), Microfinance (18%), and Housing (9%).

The regulations: First let us understand why was a holdings company structure created. According to the then RBI norms, the promoter's minimum initial contribution to the paid-up share capital of an SFB should be at least 40%, locked in for five years from the date of commencement of operations. Since in most cases the bank would have gone through a series of fund-raising, the

promoter stake was low and it was not possible for them to raise their equity to 51% without substantial investment. Hence, to work around this dilemma, a holding company structure was created and the SFB was housed in a holding company. (https://www.business-standard.com/article/finance/proposed-small-finance-banks-opt-for-holding-firm-116062200021_1.html)

Further, the RBI norms required an SFB to be listed within three years of starting operations. Consequently, ESFB was listed in November 2020. However, EHL being the holding company of ESFB suffered from a holdings company discount.

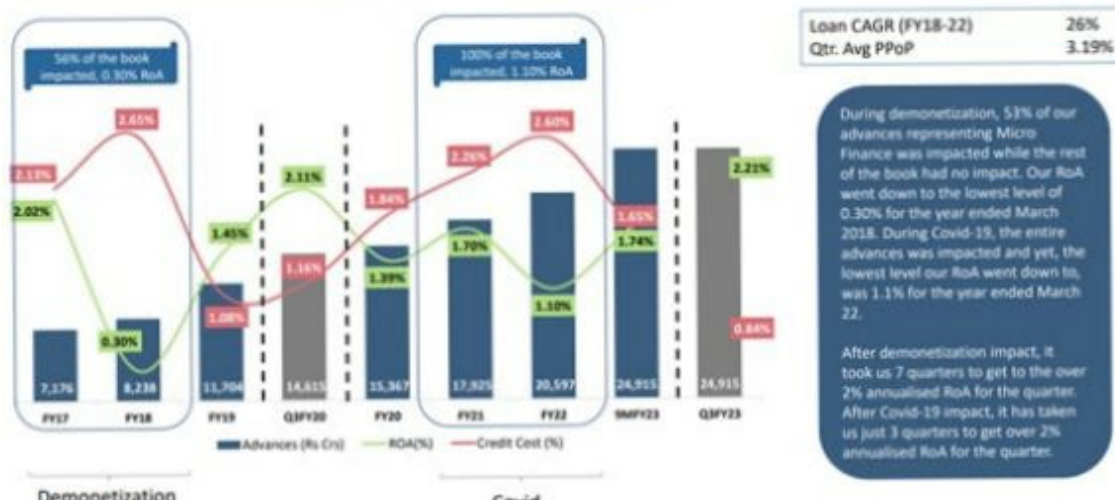
Also, RBI regulations required SFBs to dilute promoter shareholding to less than 40% within five years from starting of operations. With ESFB completing five years in September 2021, the Boards of EHL and ESFB decided to go for a reverse merger of the bank with the holding company. (https://www.business-standard.com/article/markets/rbi-allows-sfbs-to-merge-with-holding-cos-ujjivan-equitas-holdings-up-20-121071200151_1.html). This helped satisfy the above condition. As per the merger ratio, every shareholder of EHL has received 2.31 shares of ESFB. Then followed a series of approvals from RBI, SEBI, SEs, Shareholders (most important as minority shareholders have weightage), and NCLT.

What piqued our interest in Equitas Holdings?

1) In its >5 year-journey as a 'small finance bank', including 2 covid-impacted years, Equitas SFB remained committed to building a scalable, sustainable, and stable franchise with a focus on granularity and geographic diversification.

2) While the journey was temporarily disrupted by demonetization and the pandemic, management's successful execution of business strategies is reflected in 1) the share of the secured book increasing to 81% in FY22 (vs 66% in FY18), 2) CASA ratio at 48% in Q2FY23, 3) average RoA at 1.4% during FY20-FY22 on a quarterly basis, and 4) calibrated lending growth (16% CAGR during FY21-FY22).

Bank Performance Over the Cycles



Source: Company Presentation

3) ESFB stood to receive cash and bank balances of ~Rs.3 bn lying in EHL books (reported as of Sep 22). The net impact of the proposed reverse merger on Equitas SFB was likely to be book-value-accretive by ~20%.

4) The EHL stock was trading at a ~23% discount to the value of its investment in EQSB.

5) Another positive came after the founder Mr. P N Vasudevan decided to reverse his decision to step down as the MD and CEO of the company. In our view, continuity of management and his leadership was important for the Bank to sustain its growth in a stable, scalable, and inclusive manner.

6) With the completion of the merger, ESFB's strong fundamentals and Governance puts it in a good position to stake a claim for conversion to a Universal Bank.

7) NPA metrics continued to show improvements.

8) Its total deposit branch network at 375 is one of the highest within the SFB space. The total deposit base stands at Rs.217 bn (as of Q2FY23), registering 29% CAGR during FY19-22. Product innovation, robust digital platform, fintech partnerships, and attractive deposit rates drove deposit growth during the period.

The Execution: We started buying Equitas Holding at around Rs.118-122 in

December ahead of the NCLT approval (approval came on Jan 17, 2023). Post the approval, the record date was fixed as Feb 03, 2023, for the purpose of determining the shareholders of EHL who will receive the fully paid equity shares of ESFB. During the period up to the record date, the EHL stock remained in a narrow band of Rs.120-130. Post the record date, the stock was suspended for procedural reasons. Possibly, there was selling pressure from investors who would have wanted to cash out ahead of the record date to avoid being locked in till allotment of ESFB shares.

The Rally: Given the value-accretive nature of the merger, the ESFB stock saw a strong rally in February even as the banking sector underperformed due to global and domestic (Adani exposure, deposit rates, NIMs, etc). From the data released on monthly mutual fund activity, we understand that ESFB was one of the most bought stocks in February. By the time of allocation to shareholders of new shares (on Mar 10, 2023), the ESFB stock had rallied ~40% between Feb 01 to Mar 03.

However, upon receiving the fresh shares from eligible shareholders, the stock started correcting on profit booking (quite expectedly). The stock lost ~ 14% in a few sessions. We advised exiting at around Rs 66, which was well below the peak of Rs.77.9 but still managed to make 27% gains in two months. Remember, the gains came during a period when the Nifty itself declined and there was Adani-group-related turmoil.



Source: Screener.in

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